



## THE LEGAL PAD

### Recovering Damages for Loss of Bonding Capacity

By Stephen A. Hess, Esq., Sherman & Howard LLC

Bonding capacity is the life blood of the public works contractor. When a contractor's bonding capacity is limited, the amount of work it can perform is limited and the contractor's ability to grow is constrained. Indeed, when an owner wrongfully terminates a contract, the damages that the contractor suffers as a consequence of the resulting hit in its bonding capacity can be several times the damages the contractor loses from the loss of that one job.

Until recently, owners rarely needed to concern themselves with the dramatic effect of a wrongful termination on a contractor's other business, as damages for a contractor's loss of bonding capacity were rarely litigated. Indeed, in *Denny Construction v. City and County of Denver*, (Colo. Ct. App. Feb. 22, 2007), the Colorado Court of Appeals held that such damages are too speculative as a matter of law to be recovered. Under that decision, owners had the comfort of knowing they could never be held liable for the most severe consequences of a wrongful termination.

Just three months ago, however, the Colorado Supreme Court reversed the decision of the Court of Appeals and held that contractors are permitted to recover damages for loss of bonding capacity upon proper proof *Denny Construction v. City and County of Denver*, (Colo. S. Ct., Jan. 12, 2009). This decision is extremely important to contractors not only for those cases where wrongful termination decisions are litigated, but because of its prophylactic effect owners now must consider that a wrongful termination decision could cost them substantially more than the project at issue and prudent owners will work that much harder at resolving disputes short of terminating a contract.

**Proof of Loss of Bonding Capacity** - The fact that a contractor has the legal right to claim damages for loss of bonding capacity does not mean that such claims are easy to prove. In fact, they can be very document-intensive and require significant expert testimony to establish. In order to recover damages for loss of bonding capacity, a contractor must demonstrate that the owner's termination constituted a breach of the parties' agreement, that the parties contemplated at the outset of their contract that the owner's wrongful termination would likely cause a compensable loss of bonding capacity, and that the contractor can demonstrate with some degree of assurance the amount of the damages.

The first element – that the owner's termination was wrongful – is just another way of saying that the owner did not have the right, under the contract, to terminate the contractor's performance. Owners generally terminate when the contractor has allowed a material breach to remain uncured for a substantial

period, but the contract usually spells out the precise circumstances under which the contract may be terminated. As a result, the first step in any wrongful termination claim is to determine whether the owner had the legal right to terminate the contractor's performance.

The second element -- that the parties contemplated that a breach by the owner would cause compensable loss of bonding capacity – takes a little work. Few owner representatives would take a witness stand and admit they knew that a wrongful termination would cause a loss in bonding capacity. Indeed, many would attest that they know so little about bonding that they have no idea what happens from the surety side. That doesn't end the matter, however. A contractor has several tools to persuade a jury that the procurement and use of bonds is so widely understood that a reasonable owner knows precisely the result of terminating a contract and making a demand on the bond. Although bond issues can be complex at times, everyone with even a modest amount of sophistication understands that if a creditor claims you defaulted on a credit obligation – true or otherwise – your credit score takes a hit.

The third element – presenting a reasonable calculation of damages – is the final, and perhaps most difficult stage. From a broad perspective, an aggrieved contractor is asserting that the owner's breach caused a loss in the contractor's bonding capacity, which limited the number of projects the contractor could bid, which limited the number of bids the contractor would win, which limited the total work the contractor performed, which ultimately limited the total profit the contractor was able to earn. Some courts (like the Colorado Court of Appeals) have considered this entire chain of proof to be so speculative that no contractor should be allowed to even try to prove such losses. The Supreme Court now allows the contractor to make this argument, and so attention to each of these links is important.

The easiest way to prove that a default terminating causes a loss in bonding capacity would be to have the contractor's surety testify to that effect. Unfortunately, sureties guard their underwriting processes carefully and are often reluctant to volunteer this information. In many cases, the contractor must present expert testimony from an industry participant (such as a retired underwriter or broker)

to make the point. In conjunction with this testimony, if a contractor can show a long and steady history of solid (or better yet, increasing) bonding capacity with a sudden loss of capacity at the time of the termination, a jury can infer that the termination caused the loss.

The next step is to show that the contractor lost work because of the diminution in bonding capacity. Typically, the best evidence of this factor is a combination of a contractor's long standing history of bidding and winning an identifiable percentage of public works contracts, and proof of projects that the contractor was prohibited from bidding after the termination as a consequence of its lost bonding capacity. Although these factors involve some speculation, a modest amount of uncertainty will not cripple the contractor's claim, so long as the jury can reasonably calculate the losses the contractor suffered.

Finally, the contractor must show that it would have earned a profit on those jobs – again, not with absolute certainty as to the amount, but with enough confidence that the jury won't be engaged in mere speculation. As with the previous elements, the best proof is a good track record. If a contractor has twenty years of experience and can show that it has refined its bidding and performance to the point that it regularly earns 6-8% profit, for example, the jury will have a solid basis to award damages. If the contractor has limited experience or its profit on public works jobs has varied wildly, such evidence may not be very persuasive

of lost future profits. This area, too, usually requires some expert testimony.

**Summary** - The Supreme Court's decision helps level the playing field between owners and contractors by ensuring that owners can be held liable for what is often the most serious result of a wrongful termination; the contractor's loss of bonding capacity. These claims can be expensive and difficult to prove, but the mere prospect that a contractor may recover these losses will prove to temper owners' termination decisions in the future and, in at least some cases where owners elect to terminate contracts wrongfully, will allow contractors to obtain the full compensation they deserve. ✕

*Stephen A. Hess practices construction law nationally through Sherman & Howard's Colorado Springs office and is the author of numerous law review articles dealing with construction matters, including "Assessing Default Termination," Construction Briefings (February 2006) and "Recovery and Proof of Damages for Loss of Bonding Capacity," Journal of the American College of Construction Lawyers (Spring 2008). He can be reached at shess@shermanhoward.com or (719) 448-4042.*