



MANAGING CONTRACTOR DEFAULT RISK

WHY BOND?

Presented by

Lynn M. Schubert

President

The Surety Association of America

Default

One of the most disruptive events in a construction project is a contractor's failure to perform its contractual obligations, especially completion of the agreed-upon work. Performance bonds are frequently utilized to protect the hiring party (owner or contractor) from the financial impact of a contractor or subcontractor default, including the cost of finding a replacement contractor, higher contracting costs, and delays caused by the default. However, many contractors choose to self-insure this risk, and minimize the risk of default using a rigorous prequalification process to select qualified and financially secure subcontractors. Recently, several insurers have developed an insurance policy that provides a form of stop loss coverage for contractor default. In this session, learn strategies for helping your clients make an informed decision on whether to self-insure, bond, or insure this risk. Also learn how to assist your client in minimizing the financial impact of a default no matter which method of financing is selected.

Monday, November 13, 9:00 a.m.–5:00 p.m.

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Lynn M. Schubert
President
The Surety Association of America

Ms. Schubert is one of the presenters for Monday's all-day seminar, "Managing Contractor Default Risk." She is president of The Surety Association of America (SAA), a trade association of more than 650 companies that write fidelity and surety insurance. The SAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by all state insurance departments as a statistical agent for the reporting of fidelity and surety experience. The SAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

Prior to joining the SAA, Ms. Schubert was counsel in the Law and Regulatory Affairs Department of Aetna Life and Casualty Company with responsibility for all legislative and regulatory developments in the Mid-Atlantic and Southeast regions for all property/casualty and life insurance and annuity issues, and nationwide for fidelity and surety issues. Previously Ms. Schubert was corporate secretary and assistant general counsel with the American Insurance Association in Washington, D.C., in charge of fidelity and surety bonds, insurance access and availability ("redlining"), and all coordination with the National Association of Insurance Commissioners. She received her undergraduate degree *magna cum laude* in business administration from East Carolina University in 1977 and her law degree from the University of Notre Dame in 1980. She is admitted to the bar in Georgia and the District of Columbia.

Ms. Schubert currently is a member of the Board of Governors of the Florida Residential Property Casualty Joint Underwriting Association. She also is a member of the Panel of Arbitrators of the American Arbitration Association, the State Bar of Georgia, the District of Columbia Bar, the Surety Claims Institute, the Construction Group Advisory Board for Federal Publications, the National Bond Claims Association, and the Forum Committee on the Construction Industry and Public Contract Sections of the American Bar Association and is an expert commentator for IRMI.com. She is a past chair of the Torts and Insurance Practice Section—Fidelity and Surety Law Committee and a member of the Council of the Torts and Insurance Practice Section of the American Bar Association, and formerly a member of the Board of Directors of the Atlanta Council of Young Lawyers.

Ms. Schubert is a frequent lecturer on the topics of grassroots and corporate lobbying, and lectures and is an author on the substantive areas of fidelity and surety law, environmental law, antitrust law, and insurance availability and access.

Prior to joining the AIA, Ms. Schubert was a partner with an Atlanta, Georgia, law firm specializing in fidelity and surety law, and a supervising bond claims attorney for the Continental Insurance Companies.

Notes

This file is set up for duplexed printing. Therefore, there are pages that are intentionally left blank. If you print this file, we suggest that you set your printer to duplex.

WHY BOND?

Lynn M. Schubert
The Surety Association of America

- I. Introduction**
- II. Types of Surety Bonds and the Uses of Each**
- III. The Use of Contract Surety Bonds**
 - A. Prequalification of sureties
 - B. Prequalification of contractors
 - C. Drafting your bond form
 - D. Involvement of surety in preconstruction
 - E. Project status reports
 - F. Notification of surety of problems on project
 - G. Pre-default meeting
 - H. Options on default
 - I. Cooperation of all parties
- IV. Comparison with Other Insurance Products**
- V. Conclusion**

Default

Notes

WHY BOND?

Using Surety Bonds To Protect Your Construction Projects

Why do obligees spend the money to purchase surety bonds for their construction projects? The answer, in a word, is: Assurance. Assurance that their project will be completed in accordance with the contract documents, and assurance that the people who work on the project will be paid for their work.

Three types of surety bonds typically are used for construction projects.

- The *bid bond* assures that the contractor, if chosen for the project, will enter into the contract and provide any required performance and payment bonds.
- The *performance bond* assures that the contract will be completed in accordance with the contract, or that the funds will be provided to complete the project, up to the amount of the bond.
- The *payment bond* assures that subcontractors, suppliers, and laborers will be paid for their work.

Why do public and private owners buy these bonds? Although some might argue that public bodies buy bonds because they must by law, that was not always the case in the past, and certainly is not the case today. When the first federal statute requiring surety bonds on federal construction projects was enacted in 1894, it required contractors to:

execute the usual penal bond, with good and sufficient sureties, with the additional obligations that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials in the prosecution of the work provided for in such contract...

This language in the Heard Act clearly recognized that contracting officers already were requiring performance bonds on these projects even without a legal mandate. This new language merely added protection for those working on the project. This Act has been

amended five times since 1894, and Congress has yet to decide to eliminate the surety bond requirement. Clearly, the U.S. government believes that the protection provided by a surety bond is valuable.

All states and many municipalities have followed suit and now require surety bonds for public works projects of various sizes. In fact, many local jurisdictions, while not required to by state law, also have adopted bonding requirements by local ordinance or regulation. These public bodies have made a conscious decision that surety bonds provide value to construction projects.

Additionally, more and more private owners are beginning to see the value of surety bonds to their overall bottom line. Having a project completed on time and within budget is worth the minimal cost of a surety bond.

Why have the federal, state, and local governments and private owners decided to require bonds? To understand this decision, you must understand what a surety bond provides to the owner.

Prequalification

The hallmark of the surety underwriting process is prequalification of the contractor. The fundamental concept underlying contract surety bonds is that contractor default is a preventable event-not a fortuitous one. Therefore, sureties spend a great deal of money in the underwriting process in the belief that they can prevent greater expenditures for claims at the end of the day. This prequalification process benefits the obligee (the owner if it is a contractor bond, and the contractor if it is a subcontractor bond) in many ways.

First, it allows the obligee to avoid the cost of attempting to prequalify every potential bidder. In fact, it would be close to impossible for an obligee to obtain and evaluate the detailed financial and other information each surety maintains for each of its contractors. Second, it avoids the opportunity for politics in the bid award. Third, it provides an independent third-party evaluation of the bidders, and a solvent company to stand behind that evaluation.

A contractor that has been evaluated by a third party and determined to be qualified to perform the work is less likely to cause delay and disruption on the project. Additionally, if an obligee is the only entity conducting prequalification, there is no place for a contractor to go for a “second opinion.”

The surety prequalification process allows a contractor that is rejected by one surety to go to another surety with its application. Since each surety has different underwriting guidelines and target markets, often contractors rejected by one surety will find bonding with another. This allows more contractors to bid on the work, increasing competition and often lowering prices.

Although it is true that contractors which would not receive bonding in a hard market are receiving bonds today, that does not mean sureties have abandoned prequalification altogether. Both sureties and contractors have become more sophisticated in their business analysis and planning. Contractors are finding ways to expand beyond their traditional expertise and geographic limitations, and sureties are finding ways to undertake more complex obligations.

Sureties carefully review the contractor’s ability and resources to make these expansions and award bonding based on a more individualized basis rather than by following generic underwriting rules. More bondable contractors means greater competition for work, again resulting in better overall prices for obligees.

But the true beauty of this system is that while prequalification by a surety increases the odds of a trouble-free project, if the surety does issue a bond for a contractor which ultimately does get into trouble and defaults on the contract, the surety is there to ensure that the contract can be completed.

Claims

The second obvious benefit to obligees of a surety bond is contract completion. If the contractor defaults, the surety is there to ensure that the contract can be completed. In the United States, when obligees require bonds, they usually require both a performance and a payment bond, both in the full amount of the bonded contract.

Thus, if a contractor defaults, the surety could be liable for up to 200 percent of the contract price. One hundred

percent of the contract price, over and above the balance remaining in the original contract funds, is available to the obligee to complete the work. Another 100 percent is available to subcontractors, suppliers, and laborers to pay them for work performed on the project. Both of these obligations of the surety benefit the purchaser of the bond—the obligee.

The most immediately attractive benefit to the obligee is the obligation of contract completion. Most surety bonds give the surety the option to choose how to handle a default. The most recent version of the American Institute of Architects standard performance bond, for example, provides that in the event of default, a surety:

... shall promptly and at the Surety’s expense take one of the following actions:

4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; or

4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or

4.3 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:

.1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner; or .2 Deny liability in whole or in part and notify the Owner citing reasons therefor.

* * *

6. After the Owner has terminated the Contractor’s right to complete the Construction Contract, and if the Surety elects to act under Subparagraph 4.1, 4.2 or 4.3 above, ... [AIA Document A312 December 1984 Edition.]

Certainly the obligee must cooperate with the surety to evaluate the current situation and attempt to keep the project moving as quickly as possible. But the obligee is not required to:

- Find a new contractor
- Find additional funds

- Evaluate the claims of subcontractors and suppliers
- Allocate the remaining contract balances between performance of the contract and payment of unpaid subs and suppliers

The obligee essentially is protected from the difficulties these things would cause. The surety handles these matters.

Additionally, both the obligee and subcontractors, suppliers, and laborers benefit from the surety's obligations under the payment bond. If there is no payment bond, unpaid subcontractors, suppliers, and laborers will look to the owner for payment if the contractor defaults on the project. Both public and private owners will find themselves barraged by claimants wanting to be paid. These owners will have to determine the validity of each claim and how to keep these claimants working until their claim is evaluated and paid.

Owners also may be required to pay for the same work twice. Although the owner might already have paid the contractor for the work, if the contractor did not pass on the payment to the party who performed the work, the owner may have to pay again to keep the work moving. This is even more likely on a private project since private owners will find liens placed on the construction project. To have those liens released, the owner must litigate or pay the claims.

A payment bond also directly benefits the subcontractors, suppliers, and laborers on the project. The bond allows a direct claim against the surety for work performed on the bonded contract. The surety is responsible to evaluate the claim independently and pay if warranted. This allows subcontractors and suppliers to bid for work with contractors with whom they do not have a personal history, relying on the surety's guarantee of payment.

It also allows these subcontractors and suppliers to submit a bid that does not include a contingency for nonpayment, reducing the bid price. This difference in bid price might be the factor that makes the subcontractor or supplier the bidder of choice to the contractor.

Payment bonds can keep a subcontractor or supplier in business rather than facing bankruptcy. Small and emerging subcontractors particularly benefit from the protection of the payment bond as they are more likely

to be adversely affected by nonpayment on one project. This benefit to small and emerging contractors dovetails perfectly with the public policy of many public entities to encourage small, emerging, minority- and women-owned businesses.

It is important to understand, however, that a surety bond is not like an automobile or homeowner's insurance policy. The bond is a three-party agreement, and the surety has contractual duties to both the obligee and the principal. Some owners believe a surety automatically will take the side of a contractor. This simply is not the case. A surety will do what it takes to ensure that all of its responsibilities are met, both those to the contractor and those to the owner.

The surety's obligation to the owner is to perform under the bond if the contractor fails in its promise. The surety's obligation to the contractor is to not step in arbitrarily if the contractor has not failed. These same relationships do not exist with other types of insurance, and often owners do not understand the implications of this arrangement. However, this does not mean that the surety will take lightly its responsibility to the owner.

In understanding how a claim situation might unfold, you must understand all of the relationships. Since the surety's obligation is a guarantee of the contractor's promise, the contractor remains primarily liable. Therefore, the surety is responsible to the owner if the contractor fails, but the contractor remains responsible to the surety.

In other words, an owner cannot just decide that the contractor is not working to the owner's satisfaction and make a claim on the bond. The owner must determine that the contractor has breached its promise. The surety then has a duty to conduct an independent investigation. If the surety finds that the owner is correct, then the surety must perform on its obligations.

However, since the bond is a guarantee of someone else's promise, that person (the contractor) remains liable, and must repay the surety any losses. Therefore, it is in the best interests of the owner to quickly substantiate its claim of default so that the surety can move quickly in its investigation. Owners who understand these concepts use surety bonds to their best advantage.

It is clear that performance and payment bonds provide many obvious benefits to owners, contractors, and claimants. What about other reasons obligees should buy bonds?

Unseen Services of a Surety

Surety services are not limited to prequalification and claims paying. In fact, much of what a surety does is for contractors either before or when they begin to have trouble on a project. Obligees, however, seldom hear about these valuable services of the surety. In fact, if everything goes right, the obligee never will know that there was trouble.

Sureties frequently receive requests for financing from contractors. After all, if the contractor doesn't make payroll on Friday, you can be sure there will be no workers on Monday.

Sometimes a contractor in financial trouble, but otherwise qualified to perform the work, can avoid default and complete all its bonded and nonbonded work with short-term financial assistance. Of course, contractors do not want the owners or developers to know that they are in any trouble, so neither the contractor nor the surety mentions this advance to the obligee.

The needs of contractors in trouble range from something as simple as a loan to something as complex as the surety essentially taking over the contractor and assisting with completion of all projects. Avoiding a default is almost always better than cleaning up after one.

Owners can benefit most from these services if they keep the surety informed on the status of the project. If a surety hears from a project owner that there is trouble brewing on a project, the surety will become concerned.

Early investigation by the surety can provide two real benefits. First, by early investigation, the surety may be able to find a way to avoid the default. Second, if the contractor does ultimately default on the project, early notification and investigation will assist the surety in moving more quickly on its obligations. As in most situations in life, communication often is the key to success.

The Goal—Project Completion

The one thing every obligee wants—whether an owner or a contractor—is for the construction project to be completed on time, within budget, and with minimal trouble. Surety bonds can make that happen.

If a problem occurs, you want your project to continue moving forward. Sureties understand this need of owners and contractors and many have put in place systems which allow just that to happen. Proactive claims handling is common in today's surety world. Moving the project forward benefits both the owner and the surety.

The Surety Information Office (SIO) has a myriad of examples where sureties have made the difference in a successful project. They can be accessed through the SIO Web site (www.sio.org). For example, a surety's intervention kept an \$18.4 million roadway project moving despite the contractor's financial difficulties, and the project was completed ahead of schedule. The owner in that case stated, "[The surety] has proven its resourcefulness and dedication to efficient and smooth running operation" and that completion was a result of the surety's "quest for excellence and proven service."

Reading these real-life stories should convince any owner that surety bonds are a good deal.

Why You Should be Convinced— Contractor Failure

Often, owners claim they do not need the prequalification services of a surety because they only hire contractors they know, or perform their own prequalification process. Like contractors, these owners are typical construction industry people—forever optimists. They think that because they know the contractor/subcontractor and have worked with that company in the past, nothing could go wrong on their project. Yet, we all know that the rate of contractor failure belies this belief.

From 1990 through 1998, 91,096 contractors failed in the United States, leaving behind \$23,039,782,868 in liabilities (Engineering News Record, July 12, 1999, p. S-23). In 1998 specialty trade contractors experienced the most failure: 5,590, with 3,695 general building contractors and 283 heavy construction contractors failing.

These failures are not limited to new or small contractors. Five years ago, who would have thought that Morrison-Knudson, Holzman, or Guy Atkinson would be in the trouble they are or cause the losses they have? According to Engineering News Record:

Daewoo, Holzman, and Perini are among the largest, oldest, and most sophisticated construc-

tion firms in the world. If they can get into trouble, anyone can. [December 6, 1999, p.72.]

The risk of contractor failure is real, and owners and contractors must face that fact. The impact on them, however, can be minimized with good risk management. One of the best tools for risk management of a construction project is surety bonds.

Conclusion

At the end of the day, owners must determine how to manage the risk of construction in the way best suited for their own operation. A careful analysis of the true services, benefits, and costs of surety bonds should be enough to convince any owner to include bonds in their arsenal of risk management tools.

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