2023 Surety Bonding and Construction Risk Management Conference

Setting the Stage for Success with Surety Bond Claims

By: Scott MacColl & Richard Towle, Innovative Surety Solutions LLC

THIS PAPER WAS WRITTEN IN CONJUNCTION WITH A BREAKOUT SESSION AT AGC'S 2023 SURETY BONDING AND CONSTRUCTION MANAGEMENT CONFERENCE

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Scott MacColl & Richard Towle

Innovative Surety Solutions LLC

AGC's 2023 Surety Bonding and Construction Risk Management Conference

January 30 – February 1, 2023

Hyatt Regency Coconut Point Resort and Spa, Bonita Spring, Florida

Surety bonds provide a powerful risk mitigation tool to address complex situations such as construction projects. Effective preparation, documentation, communication, and collaboration among the various stakeholders will help set the stage for a successful surety bond claim. This document touches on some important factors to achieving a successful surety bond claim but is not intended to address all factors or scenarios that may arise.

Clarity of Legal Documents Including Bond Forms and Underlying Contracts

Bond forms and underlying contract documents should provide clear guidance regarding stakeholders responsibilities throughout the relationship. Effectively crafting legal documents to address performance and payment issues starts by focusing on the common objectives of the stakeholders along with an understanding of the options available to the surety in the event of a dispute or default (see Surety's Role section). The bond form typically addresses the primary responsibilities of the stakeholders relative to the obligations assumed; However, the underlying contract document, incorporated into the bond by reference, may also have relevant provisions of which the stakeholders should be aware. Some bond forms lay out specific conditions and requirements to trigger the surety's obligations, while others contain what appear to be broader options with less specific requirements. The differences between the AIA A312 and A311 provide an example for consideration. Obligees and principals should evaluate the benefits and risks of utilizing documents that contain more specific conditions and may appear more restrictive, such as the AIA A312, versus those appearing to have fewer conditions and appearing to offer broader options, such as the AIA A311.

Effective and Appropriately Detailed Documentation

Representatives of the obligee and principal having management and oversight responsibilities for the bonded obligation should have a good understanding of the stakeholders rights, responsibilities, and options, which will allow them to effectively direct, document, and communicate with the parties as appropriate.

Surety claims involve a retrospective review of what has transpired to evaluate where the stakeholders have, or have not, met their obligations to the other parties. It is therefore incumbent on the obligee and principal to maintain clear and appropriately detailed records to support actions taken to fulfill their own obligations as well as actions, or inaction, by other stakeholders that may impact the contractual obligations.

Robust Communication and Collaboration

Collaboration and effective communication between the obligee and principal are important to achieving common objectives, minimizing misunderstandings, and avoiding disputes. Disputes and issues will arise on occasion, even when best practices for documentation and communication have been utilized. It is beneficial to initiate collaborative communications with the surety when initial signs of potential problems arise. This presents an opportunity for the obligee, principal, and surety to work together in completing the contract objectives before disputes become intractable and arguments become contentious.

Avoiding Delays

All stakeholders have an interest in avoiding unnecessary delays. Effective preparation, documentation, and communication before and during the life of a contract are important factors that will enable stakeholders to set the stage for success even when the unexpected issues arise.

Surety's Role

It is important for the stakeholders to know and understand what options are usually available for the surety. The options discussed below are the standard options available to the surety in response to a valid claim on the surety's performance bond. For purpose of this paper, it is assumed there has been either a voluntary default by the bond principal, or that the surety has determined that the obligee has properly defaulted/terminated the principals' contract.

The goal of any surety managing a performance bond claim is to perform the surety's obligations under the bond in a fair, reasonable, efficient, and economical manner. The surety has options to consider when responding to a performance bond claim. The major options available to the surety are: (1) financing the principal, (2) the takeover of a project from a defaulted principal and the project's completion by the surety, (3) the tendering of a new contractor to the obligee for the completion of the defaulted project, and (4) the completion of the bonded project by the Obligee.

Financing the Principal

By using the "financing the principal" option, the surety's objective is to remedy a potential or existing default under the bonded contract, and to avoid a termination of the principal's rights to complete the bonded contract. Before financing the principal, the surety will review the four "C" of the principal, cash, capacity, character, and collateral. The surety will need to determine how much cash the principal has and more importantly how much cash the principal will need to complete the project. The capacity component, the surety will investigate the technical abilities of the principal, the principal's management abilities and the principal's ability to close out projects. For Character component, the surety will review the character of the principal and their indemnitors, looking at their honesty, integrity, and trustworthiness. The last of the four "C" is collateral. The surety will be looking to see if the principal and their indemnitors has any additional collateral they can posted such as securities, properties, and affirmative claims.

Methods of Financing

There are several methods for the surety to provide financial assistance to their principal. While providing financial assistance, the surety must make sure that the bonded contract proceeds are collected will be used by the principal to complete the bonded contract and pay for the labor and material used in completing the bonded contract. To accomplish this assurance, the suety will usually use a "special account: into which the bond contract funds are deposited along with any funds advanced by the surety.

One of the methods the surety can use to finance the principal is directly advancing or loaning money to the principal. Often the surety will advance funding in the short term to fund critical needs such as payroll and critical subcontractors and suppliers. This type of funding is often referred to as "look-see" financing. These "look-see" funds are used to keep the bonded contract moving while the surety performs their investigation into the best way to fulfill their obligation under the performance bond.

Another method of providing the principal with financial assistance is for the surety to guaranteeing a bank loan which makes available funding from third parties. This option can be used if the principal has collateral security for the bank, but the bank is unwilling to lend without the additional guarantee from the surety. One situation where this option can be helpful involves federal contracts. With federal contracts, the United States do not recognize assignment of contracts to sureties, but they do recognize assignments involving financial institutions.

It is often the situation that the principal requires financial assistance to fund current payroll and current bills due subcontractors and supplies due to poor or slow cashflow. The surety can provide financial assistance by paying certain projects debts as payment bond claims. By providing this type of assistance, subcontractors and suppliers are less likely to slow down the progress of the bonded project. By its payments to subcontractors and suppliers, the principal can apply future bonded contract funds to the future completion of the bonded project.

Another indirect method of providing financial assistant is for the surety to provide additional bonding to the principal. This option is a very difficult option to use. The surety will be very selective in using this option. This option does not provide cash to complete the bond contract. This option may help clam the market rumors and the principal's workforce. This option will not solve the problem if the principal has problems beyond a temporary cash flow problem.

There are advantages to providing the principal with financial assistance. Following is a partial list of these advantages: (1) the Learning Curve, (2) Demobilization and/or mobilization/job momentum and continuity, (3) New Contractor markup, (4) Principal's image and presence and the preservation of affirmative claims, and (5) existing subcontracts.

The Learning Curve can be very expensive. The principal's management, the project's workers, and project subcontractors are familiar with the project. Any new contractor will require a certain amount of time to become familiar with the scope of work before they will become productive. Any new contractor will factor this additional time into their price to complete the bonded contract.

If the bonded project is shut down because of a termination, the principal and its subcontractors will likely demobilize the project. This demobilization costs will possibly develop into payment bond claims. Any new completion contractor will include its price to complete their mobilization costs. Avoiding this demobilization and mobilization progress on the project should continue with any delay minimized.

When the completion contractor will estimate their cost to complete the project. As part of their estimate the completion contractor will include a mark-up on their bid for both profit and overhead. The surety often experiences a mark-up which is higher than normal due to perceived risk associated with taking over a defaulted project. By keeping the principal on the project, the surety can possibly avoid this cost.

The surety by providing financial assistance helps the principal maintain their image and presence in the marketplace. By helping maintain the principal's presence on the project and in the market, the principal can maintain their relationship and their contractual arrangement with their obligees and their subcontractors. Without the principal the surety's costs of dealing with the obligee and subcontractors usually increase.

By assisting the principal, the existing subcontracts remain in place. Often when a principal is terminated, the surety will experience the subcontractors attempting to renegotiate their subcontracts resulting high costs for the surety.

There are disadvantages to providing the principal with financial assistance. Following is a partial list of these disadvantages: (1) No credit against the performance bond penal sum, (2) does not fix the loss amount for the suety, (3) the payment of items not covered by the bond, (4) the cost of monitoring, (5) completing the work – the 10% problem and tail-end let down, and (6) Potential problem of reinsurance.

Unless agreed to by the Obligee any funds advanced by the surety to the principal will not decrease the penal sum of the performance bond. If the projected cost to complete the project is close to the penal sum of the performance bond, it is unlikely that the surety would agree to finance the principal.

One of the key objectives of the surety is fix the amount of their loss. By financing the surety will not be able to fix the final amount of its loss until the bonded contract is completed. If the surety decides to finance the principal, they are assuming the same risks as any other contractor.

When the surety agrees to finance the principal, it is likely that they will be required to pay some of the principal's overhead and general operating and administrative expenses. These types of expenses ae not covered by either the performance bond or the payment bond. If the principal has unbonded work, the surety may need to pay subcontractors and suppliers on unbonded work to get them to perform on the bonded projects. Financing the principal will increase the surety's loss because of the need to pay unbonded obligations.

The cost of monitoring the work of a financed principal can be high. The surety's representatives will need to spend substantial time with the principal to ensure that the work is being completed, contract billings are being submitted timely and collected, and that the subcontractors and suppliers are being paid timely. The surety will frequently retain construction consultants, accountants, and legal counsel to assist with the monitoring process.

When financing, the surety frequently experiences the "ten percent problem". As the project gets closer to completion (the last 10%), the principal and their employees may have less interest in completing the project. In fact, there may be an incentive to prolong the work to obtain a paycheck. This can usually be address with some type of completion bonus.

The surety must make sure that their reinsurance treaties allow financing of the principal with many treaties requiring prior approval before the surety commits to financing of the principal. (Silverstein, 2005)

Takeover and completion

The primary advantage for the surety in takeover of a project from a defaulted principal and completing the project are (1) the surety's ability to control the costs, (2) possible measure of goodwill from the Obligee by being willing to complete the project and (3) the negotiation of a takeover agreement with the Obligee to be used in the completion of the project.

The surety can control the costs of completing by retaining a qualified completing contractor at a competitive price. This is usually done by getting multiple bids from potential completing contractors.

By the time the surety gets involved with the Obligee, Obligee relationship with the principal has deteriorated. The surety may gain a measure of good will from the Obligee by being willing to complete. A surety will often find the Obligee is willing to discuss resolutions of issues such as delay damages, unresolved change orders, and time extensions.

The most important part of the takeover and completion process is the takeover agreement. This agreement is important to address many issues such as (1) the remaining scope of work, (2) status of pending change orders, (3) the contract balances, and (4) the allocation of responsibility for corrective work.

The disadvantages of the takeover and completion option are (1) the Obligee must be willing to enter into a takeover agreement, (2) Once the surety enters the takeover agreement, they must see the project through to completion despite whatever problems may develop and (3) the surety is exposed unknown risk.

Some examples of possible unknown risks are: (1) the quality of the principals' work, (2) how far into the future doe the project completion extend, (3) the cost of consultants in monitoring the project, (4) the accessibility of the project to both the surety and their consultants during their investigation, (5) whether the Obligee agrees to cap the surety's loss at the bond penal sum, (6) the level difficulty of the work, (7) how well the project is organized, (8) how onerous the Obligee is, (9) the prospect of numerous change orders, and (10) how good the project specification are.

Tender of new contractor by the surety

Instead of the surety entering into a completion agreement with a completing contractor, the surety will offer or "tender" a new contractor to the Obligee. The Obligee will then enter into a contract directly with the tender contractor. The Surety pays any deficiency in the existing contract balance up to the price to be paid to the new contractor or the penal limit of the bond; whichever is less. There must be a willingness of the obligee to accept a "tendered" new contractor

The advantages of tendering are (1) allows the surety and the obligee to extricate themselves from an otherwise acrimonious relationship, (2) surety can ascertain its loss with certainty insulating itself from continually being exposed, and (3) the surety will have lower expenses. Tendering option tends to work on project projects just commencing or less than 25% complete

The disadvantages of tendering are (1) time (it takes time to get a new contractor), (2) potential cost and (3) Obligee may not completely release the surety.

Completion by the Obligee

There are occasions where the surety will elect not to participate in the completion of the defaulted project allowing the Obligee to complete the bonded project. There are several factors to consider where a surety might want to respond with payment of money damages rather than participating in the completion of the bonded project. Some of those factors are: (1) Simplicity, (2) ability to limit liability to the penal sum of the bond, (3) the lack of control of the costs incurred by the obligee, (4) gaining addition time to investigate, (5) reservation of defenses, (6) contract funds will be dedicated to the completion of the bonded project, (7) cash settlement provides closure to the surety and the Obligee, and (8) potential exposure to the surety's reputation and marketing ability.