Building Your Quality of Life

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AN OVERVIEW OF THE CONTRACT SURETY BOND CLAIMS PROCESS

Building Your Quality of Life

Developed by the
Associated General Contractors of America
Surety Bonding Committee

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I. Introduction

A surety bond is a three-party contract. One party, the surety, promises, in accordance with the terms of a bond, to answer for the default of another party, the principal. The third party, the obligee, is protected by the bond. Typically, the principal and surety will promise to perform or pay the obligee up to a stated amount of money for damages if the principal fails to perform its contract obligations. A fourth party, the surety bond producer or "bonding agent," is not actually a party to the bond, but is a resource to the other parties and may have a facilitating role in a claims situation.

When a prime contractor furnishes the bonds, the project owner will be the obligee and the prime contractor will be the principal. When the prime contractor requires the bonds from a subcontractor, the subcontractor will be the principal and the prime contractor will be the obligee.

Although the surety is almost always an insurance company, the surety bond is not a typical insurance policy. The surety provides financial assurance of its principal's performance. The surety does not "assume" the primary obligation, but is secondarily liable. The principal remains primarily liable for performance of its contract. The principal must reimburse the surety for any loss the surety may suffer by virtue of the surety having extended surety credit to back the principal's performance. The obligee is protected by the bond against financial loss as a result of the principal's default. The bond does not, however, guarantee that disputes will not arise between the obligee and the principal.

A surety bond assures that the bond principal will perform its contract or pay what it owes. If there is a legitimate dispute between the principal and obligee, the surety is not normally in a position to resolve it. That does not mean, however, that the surety will turn its back on a project dispute or disagreement. Disagreements can become disputes. Disputes can become breaches of contract. Breaches of contract can become defaults that justify termination of contracts. Everyone involved in the surety process is interested in avoiding that progression.

There are three primary types of contract bonds-bid bonds, performance bonds, and payment bonds. A bid bond provides financial protection to an obligee if a bidder is awarded a contract pursuant to the bid documents, but fails to sign the contract and provide any required performance and payment bonds. The bid bond helps to screen out unqualified bidders and is necessary to the process of competitive bidding.

A performance bond provides assurance that the obligee will be protected if the principal fails to perform the bonded contract. If the obligee declares the principal in default and terminates the contract, it can call on the surety to meet the surety's obligations under the bond. Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.

A payment bond provides assurance that the principal will pay for labor and material furnished for use on the bonded contract. Payment bonds are provided primarily for the benefit of the principal's suppliers and subcontractors on a project. With that benefit come certain obligations to notify the surety or the contractor of non-payment in a timely manner. In many states, the time periods for sending notices or enforcing claims are set by state laws. There are also laws governing payment bond claims on federal projects.

While most bond forms are simple documents, often no more than two pages in length, the rights and liabilities of all of the parties to a surety bond; the principal, surety, and obligee, can be quite complex. With surety bonds, as with other contracts, it is crucial to read the bond to determine the respective rights and obligations of the parties.

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This publication is only a starting place to understand the claims process. Whether you are a principal, an obligee, or a supplier with a claim, there is simply no substitute for sound professional advice by a qualified attorney or surety professional.

II. What Should an Obligee Expect in a Performance Bond Default Situation?

A performance bond provides assurance that the obligee will be protected if the principal fails to perform a bonded contract. It is a financial "safety net." The performance bond does not guarantee that there will be no disputes or disagreements. While bonded contractors are pre-qualified, the bonding process does not guarantee peace and harmony when disputes arise. An obligee should not expect otherwise.

The most frequent complaint by obligees in default situations is the speed at which decisions are made and action taken. Most contracting parties are slow to declare a default. They often provide opportunities to the principal to cure a perceived default. They may tolerate imperfect or slow performance for extended periods of time while the other party promises improvement. By the time a default is actually declared, the obligee may be at wit's end. Perfectly rational general contractors that would never think of giving a mechanical subcontractor less than two weeks to properly price and scope its work for a bid in a very controlled situation find themselves demanding that the surety, an insurance company without a tool box to its name, mobilize in the midst of controversy, properly assess the status of the work, present a plan for the completion of a half-complete mechanical system, and commence productive work in less time. It simply cannot happen.

The surety may ultimately be liable for the delay, but it has very limited ability to avoid or greatly shorten the time impact of a default, no matter how good its intentions. Early communication with the surety vastly improves the surety claims process. A surety's ability to limit the impact of a default is directly related to whether or not the obligee has kept the surety informed of the status of the project, how quickly the obligee provides needed information when a default is declared, and the level of cooperation of both the principal and the obligee.

Some performance bonds, including the American Institute of Architect's A312 form, require a meeting among the obligee, principal, and surety prior to any declaration of default. Even if the bond does not require it, such a meeting is almost always useful. If there are such serious problems on the job that the obligee is considering a termination for default, the surety should want to know about it, and the obligee should want to involve the surety. Surety claims professionals are experienced in dealing with troubled projects, and the surety can often help avoid a default termination. It is at this initial meeting stage that the professional bond producer may be of great value to the process, as a confidant of both the surety and the principal.

If the bonded contractor is otherwise competent but does not have the capital necessary to complete the project, the surety may advance funds to finance completion by the principal. If that occurs, the obligee should be willing to make future payments as joint checks or as otherwise requested by the surety to assure that funds from the bonded contract are used only to pay obligations on the contract. The surety and the obligee have a common interest in seeing that contract funds are not diverted from a bonded project.

One of the often unseen benefits of surety bonding is the situation where a surety takes control of contract funds and provides additional capital to a failing contractor to prevent a default in the first instance. This may happen without the obligee even knowing that a problem existed. This happens more often than many obligees realize.

Two contractors cannot perform the same work at the same time. That is one reason most bond forms make the formal termination of the principal's contract a condition precedent to the surety's performance obligations. Although sureties will insist that they cannot assume responsibility for performance unless the contractor is defaulted, that does not mean they cannot and should not investigate the problems and consider alternatives prior to the termination. Early warning and cooperation are always helpful in minimizing everyone's losses.

If the obligee does decide to terminate the bonded contract and call upon the surety, the surety and the obligee generally have a number of options. Some bond forms spell out the options and make them part of the agreement. Some forms are silent on the subject of performance default options. Whether or not the bond spells out the options, or even if the options in the bond are limited, it always makes sense to explore all possible options for the resolution of disputes and the completion of bonded work.

One option is for the surety and the obligee to agree on a replacement contractor to complete the bonded work. This is often referred to as the surety's "tender option," because the surety "tenders" a new contractor to the obligee. If the replacement contractor's price exceeds the balance remaining in the bonded contract, the surety will fund the excess either by paying the replacement contractor as the work proceeds or by paying the obligee the amount of the overrun in return for a release. Under normal circumstances, the obligee and the surety will insist that the replacement contractor provide new bonds to guarantee its performance of the completion work. One advantage of this tender option is that the obligee can deal directly with the new contractor in administering the project.

A second option in the event of a default is for the surety itself to assume or "take over" responsibility for completing the remaining work. The surety, of course, would then hire construction professionals to manage and perform the completion. Although it is possible on a given job that a consultant or construction manager is all that is needed and the original subcontractors can perform the completion work, it is more common for the surety to hire a completion contractor. The delivery method by which the work is completed will depend largely on the status of completion. A surety is more likely to elect this option for a job that is well along in performance.

If this second takeover option is used, the surety and the obligee will enter into a "Takeover Agreement" spelling out their respective rights and obligations in connection with completion of the work. Although some have suggested that a Takeover Agreement is unnecessary, and that the surety should just show up and commence work, the better practice is to avoid misunderstandings and disputes later on by entering into a definitive written agreement.

A third option following default of the principal is to advise the obligee that the surety elects not to be involved in the completion work. This is usually an available option, regardless of the options spelled out in the bond. A responsible surety that elects this course of action should do so promptly, so that the job is not unduly delayed. The surety, of course, remains exposed to liability for the costs to complete in excess of the remaining contract balance. And, because this option leaves the surety with little or no control over the manner in which the work will be completed, such an option is only reluctantly taken by the surety. The most common situation in which the surety elects this option is if it believes the default termination of the principal was unjustified in the first instance or that the obligee's demand or position is overreaching. The obligee that can ill afford to finance completion and seek reimbursement later is well advised to consider the reasonableness of its initial demands.

Other options are limited only by the facts, the resources, and the creativity of the parties involved. These range from up-front cash settlements, to continued performance by the original contractor, possibly with additional monitoring, to various combinations of all of the available options. The obligee or the surety that insists that the default be remedied only in one way may often miss opportunities for savings in time, money, and heartache.

Even if there is a dispute over the propriety of the termination, all three parties to the bond have a common interest in seeing the work is promptly completed with as little cost and delay as possible. The fact that they disagree on the existence of a default does not necessarily prevent cooperation to complete the work. In an appropriate situation, for example, the surety can take over the work or tender a replacement contractor under a "reservation of rights." Under such an arrangement, the parties agree that if it is determined that the default was wrongful, the obligee will pay the surety any excess costs. If the obligee is certain the default was proper, it runs no risk in making such an agreement.

III. What Should A Payment Bond Claimant Expect?

A payment bond, sometimes called a "Labor and Material Payment Bond," is required by the obligee, but the bond is primarily for the benefit of the principal's suppliers and subcontractors. The bond obligates the principal, whether a contractor or subcontractor, to pay for labor and material furnished for use in performance of the bonded contract. The claimants are usually limited to subcontractors or suppliers to the bond principal or sub-subcontractors or suppliers to a subcontractor of the principal.

Claims against payment bonds are sometimes made against financially sound principals that have breached no obligations to the named obligee. This occurs when a claimant has no contract with the principal but has not been paid by the principal's subcontractor or sub-subcontractor. The fact that the principal has paid its subcontractor is not normally a defense to a claim by an unpaid sub-subcontractor or supplier to the subcontractor. The bond principal, therefore, can find that it has to pay twice for the same work – once to the subcontractor and again to the subcontractor's supplier. To give the principal an opportunity to protect itself from such double liability, most bonds require that a claimant that does not have a contract with the principal give the principal or the surety, or both, written notice of its claim within a relatively short time after the claimant furnished the labor or material for which claim is made. In some cases, the time period runs from the date of the last of the claimant's work. In others, it may run from the date of each delivery. The terms of the bond and any statutes governing the bond will control those deadlines. Courts strictly enforce such notice requirements. Therefore, a prudent potential claimant should begin preparations for a claim soon after the debt is incurred. Some subcontractors and suppliers request copies of bonds before they make any deliveries, so that they are fully aware of any notice requirements.

A payment bond claimant already may consider its account "past due" by the time it turns to the surety. Just like the performance bond obligee that believes it has already lost too much time accommodating the principal, the payment bond claimant is anxious for payment. The surety, on the other hand, may have no direct involvement in the project and no prior knowledge of the claim. The best way for a claimant to speed up the claim process is to write the surety, explain the claim, submit full and complete documentation supporting the amount owed, and ask for any forms or affidavits the surety needs to allow the claim. The surety will typically want to receive copies of any subcontract or purchase order under which the work was performed, invoices to the principal or the principal's subcontractor, a record of payments and how they were allocated, and delivery slips or other documents showing delivery of material to the job site.

The surety will want to obtain its principal's position on the claim, and if the claimant has correspondence or other documents from the principal acknowledging that the claim is owed, it should submit them with the initial claim letter. It should also provide any supporting material the surety requests and follow up to see if anything else is required. The more documentation the claimant can provide early in the process, the faster the surety can examine the claim and respond.

The surety typically will acknowledge receipt of the claim and ask for any missing information. The surety will also contact the principal and ask for its position. A bond claim is not a way to pressure the principal to pay something it legitimately believes is not owed. A bond claim is not a way to nudge a principal into more timely payment. A payment bond claim is a safety net against a credit decision gone wrong.

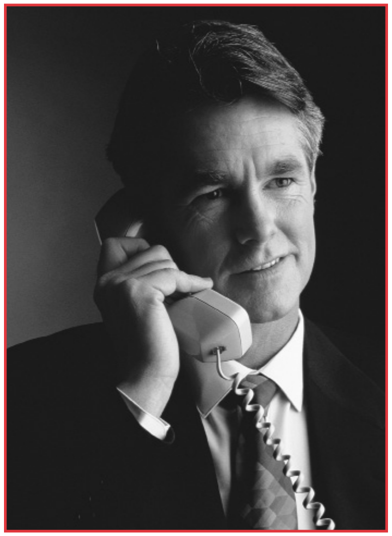
The vast majority of payment bond claims are resolved amicably and promptly, usually by the principal. When the principal has clearly defaulted in its payment obligations, the surety should be expected to promptly pay those claimants that have established the validity of the debt and have met the notice requirements of the bond. The surety should not be expected to pay claims without regard to their merits, but it should be expected to respond to claims promptly and, if it denies a claim, to explain its reasons.

IV. Reasonable Expectations in the Claim Process

None of the parties enter into contracts with the expectation of a default. When one occurs, or is claimed to have occurred, there has been a failure somewhere. This is so even if it is only a failure in communication or expectations and not a true default. By the time an obligee makes the difficult decision to terminate a contractor, the principal and obligee are often frustrated, distrusting, and unhappy with each other. The unique facts and circumstances of the project, the personalities of the parties involved, the exact terms of the bonds, and differing state laws on bonds and contracts mean that no two default situations are ever quite the same. Hard and fast rules or guidelines as to any party's expectations are difficult to establish.

At a time when communication may already be strained, there is a heightened need for effective communication by all parties. This factor cannot be overemphasized.

In rare circumstances, a default is crystal clear. The bonded contractor is in bankruptcy and has admitted that it cannot fulfill its obligations. It may have agreed that the obligee has not contributed to the default. In such a circumstance, the surety should be able to act relatively quickly. Short of that, there are investigations to be made and options to be considered. Any unilateral action by the surety to blindly heed the demands of either the obligee or the principal may result in perceived unfairness to one or both. In all instances, an obligee should expect a prompt response from the surety to the notice of declaration of default, communication while the investigation takes place, and a decision within a reasonable period of time.



Each party to the process should communicate openly and candidly with the other parties. The timeliness of the surety's response depends on it. Most defaults don't occur overnight. They are the product of a number of causes over an extended period of time. They can seldom be remedied overnight. Any party to the problem can greatly increase the likelihood of a good result by communicating promptly, factually, and objectively.

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The construction industry has pioneered many effective dispute avoidance procedures. Partnering, Dispute Review Boards, and contract requirements involving "step negotiation" are good examples. In some cases, those processes fail. There are legitimate disputes that seem destined for resolution by litigation or arbitration. The vast majority of civil litigation ends in settlement. The variable is the time and expense it takes to reach the point of settlement. Mediation, facilitated negotiation, and other "real time" dispute resolution techniques have proven to be effective and economical ways to achieve such settlements at a fraction of the cost of litigation. Most surety companies support the use of these dispute resolution techniques for the prompt and effective resolution of performance and payment bond claims. These same techniques may also be used at the time of default, before any formal adversary proceedings have been initiated.

V. Conclusion

The bond principal, the claimant or obligee, the surety, and the principal's bond producer have many common interests in the prompt and fair resolution of bond claims. No one in the construction process benefits from prolonged and needless disputes. If the claimant has reasonable expectations, communication lines remain open, and each party is committed to acting responsibly, most claims can be amicably and successfully resolved, providing the obligee with the protection the bond assures.