Surety

by Mark H. McCallum and Robert J. Duke

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KNOW YOUR BOND BEFORE YOU SIGN

A contractor needs to understand the meaning and implications of a surety bond's terms. A surety bond is a three-party agreement in which one party secures a second party's performance to a third party.

Contract surety bonds typically secure the performance of construction contracts. More specifically, a performance bond secures, for the benefit of the project owner, the contractor's performance of the contract, and the payment bond secures, for the benefit of subcontractors and suppliers, the contractor's obligation to pay its subcontractors and suppliers. If there is a default of the underlying obligation (the construction contract), the surety steps in to remedy that default.

In our article in the July 2008 edition of *Construction Business Owner*, we noted that a performance bond usually incorporates the underlying construction contract. (Go to www.constructionbusinessowner.com and search for "Surety Bonds: The Best Way to Prevent Subcontractor Default" to read the article.) Thus, an important part of the surety underwriting process is to know and understand the terms of the construction contract.

In addition, a performance bond and a payment bond have terms and conditions that are included in the form itself. Along with the terms of the construction contract, the terms included in the bond form determine the risk undertaken by the surety and contractor. (Remember, a contractor signs the bond as well. In addition, the surety has a right to recoup losses incurred under a bond from the contractor through indemnification. The contractor bears the ultimate financial risk.)

The contractor also must be aware of onerous terms that increase the risk for the surety and contractor beyond reasonable levels. Awareness of the bond terms is especially critical, considering that the form is not prescribed by the contractor or surety but by the project owner. The forms have some, but very little, room for negotiation. Thus, the surety and contractor must be fully knowledgeable of the risk.

Inclusion of one-sided terms and language that shift risk inappropriately and unbalance the rights and responsibilities among the parties is in no party's best interest. Experienced construction project participants know that onerous terms encourage parties to pass on contracts that include such terms, thereby lowering the competition for those projects, or, alternatively, to incorporate significant cost contingencies, thereby increasing the overall price of those projects.

Further, the presence of onerous language likely will have an overall negative impact on the project; it sets a "win-lose" environment for the parties' relationship from the "get go," which, in turn, may lead to adversarial posturing and contentious relations throughout the life of the project. Acceptance of an onerous contract or bond ultimately may mean assuming risks that, when realized, eliminate profits on the project or, if severe losses occur, the insolvency of one's construction business.

Anatomy of a Bond Form

A bond form has three main parts. The first part is the "binding paragraph." It identifies the three parties to the bond and states that the surety and principal (the contractor) are jointly and severally bound to the obligee (the project owner). This paragraph also establishes a financial limit to the obligation owed to the project owner. This limit is called the "penal sum."

The second part of a bond form is usually quite short, and much of the substance of the obligation is included in the construction contract. Thus, the construction contract is included in the bond form by reference. For example:

> The conditions of this obligation are such that whereas the Principal entered into a certain contract, hereto attached, and made a part hereof, with the State of Texas, acting by and through the Board of Regents of The University of Texas System for and on behalf of _______
> ________________________
> ________________________,
> ________________,
> dated ____________, _______,
> for ________________________
> (Project No. _______).

The next paragraph includes the condition and coverage of the bond. It usually states that the condition of the obligation under the bond is that the contractor will perform the contract. If the contractor so performs, then the bond is "null and void." If the contractor does not perform, the bond remains "in full force and effect" and the surety's obligations are triggered. For example:

> NOW THEREFORE, the condition of this obligation is such that, if the Principal shall faithfully perform the said Contract in accordance with the Plans and Specifications and Contract Documents, and shall fully indemnify and save harmless the State of Texas from all cost and damage which the State of Texas may suffer by reason of Principal's default or failure so to do and shall fully reimburse and repay the State of Texas all outlay and expense which the State of Texas may incur in making good any such default, then this obligation shall be null and void, otherwise it shall remain in full force and effect.

This is the key paragraph under which the project owner seeks coverage under the bond. The surety's obligations are conditional, and they are triggered by the contractor's failure to perform. The bond is "in effect" if the contractor defaults.

Essentially, a bond form needs only these three parts: a binding paragraph, a reference to or description of the underlying obligation and the bond condition. However, the need for greater specificity or the desire to expand the scope of the surety's obligations has caused the addition of other provisions. These provisions address such issues as the claims process after the contractor is in default, waivers of certain rights of the surety and the duration of the surety's obligation. These additional provisions are the provisions where onerous language can be found that increase both the surety's and contractor's risk.

Problematic Bond Language

Below are examples of some common modifications to bond form language that are problematic from the surety's perspective.

Language that makes it easier to trigger the surety's liability

Sometimes, a bond obligee will insert language which, in effect, acts as a "hair trigger" to invoke the surety's liability. For example, language may be inserted in a performance bond that "any breach," regardless of the materiality or significance of the breach, will constitute grounds by the obligee to invoke the surety's liability. The customary trigger for the surety's bond obligations is the default of the bond principal. A default requires a substantial, or "material," contract breach which justifies the termination of the construction contract. However, many contract breaches do not rise to the level of a material breach. By saying "any" contract breach, the project owner might argue that the bond permits the obligee to make demand upon the surety for even insignificant deviations from the contract requirements. This may give rise to an anomalous situation in which the construction owner may make demand on the surety bond even though the owner is not justified under the terms of the construction contract to terminate the construction contract for default.

Language that varies the burden of proof

Likewise, language may be placed in the surety bond providing that the obligee shall be the sole judge of whether a default has occurred for purposes of invoking the surety's liability. Recently, one Pennsylvania school board presented prospective bidders with a bid package containing a performance bond form that stated, in part, the following:

"WE FURTHER AGREE that if, *in the opinion of the Board* (emphasis added), that any default shall happen on the part of said Principal, we will pay all loss occasioned thereby, and that the ascertained amount thereof which *shall be determined by said Board* (emphasis added) and of the truth of which oath or affirmation shall be thereto made by the President of the said Board, or by any member thereof, shall be final and conclusive upon us, and that execution may forthwith issue against us for the amount of said default."

This language also establishes that the obligee—that is, the school board—will be the sole party which determines the amount of the loss occasioned by the contractor's default and to be paid by the surety and that the determination shall be "final and conclusive." Clearly, such one-sided language may place the construction business owner and its surety in an untenable situation with little recourse to contest an interested party's sole determination of the contractor's performance.

Language that increases the surety's monetary liability beyond the original penal sum of the bond

Obligees sometimes place language in performance bonds that would automatically increase the bond penal sum commensurate with the amount of each additive change order. In most circumstances, especially when the performance bond has been set in the amount of the original contract price, such a modification is not necessary—that is, the performance bond still covers the obligation to complete the work of change orders. However, by increasing the penal sum of the bond, the obligee increases the monetary limit of the surety's liability beyond the original contract price, which, in most circumstances, is not needed since a portion of the work will have already been put in place, and the project will be progressing toward completion.

Often coupled with the automatic increase in the bond penal sum is a requirement that the surety waive notice of or consent to such bond penal sum increases. By agreeing to language that waives the surety's consent to increases in the bond penal sum, surety will not be entitled to notice of such increases and may not know its ultimate liability. The surety could inadvertently assume a bond limit of liability that exceeds the maximum exposures set in its reinsurance treaty or could exceed the maximum bond a surety is permitted to write under state or federal regulation.

A recent legal decision in Virginia, *Centex Construction v. ACSTAR Insurance Co.*, 448 F.Supp.2d 697 (E.D.Va. 2006), provides an illustration of the danger that can result from acceptance of a clause waiving consent to automatic adjustments to the bond penal sum. In that case, the original subcontract amount was for approximately $170,000, but additive change orders increased the subcontract amount dramatically to more than $2.5 million. Ultimately, claims were made against the performance and payment bonds, which included language stating that "any increase in the Subcontract amount shall automatically result in a corresponding

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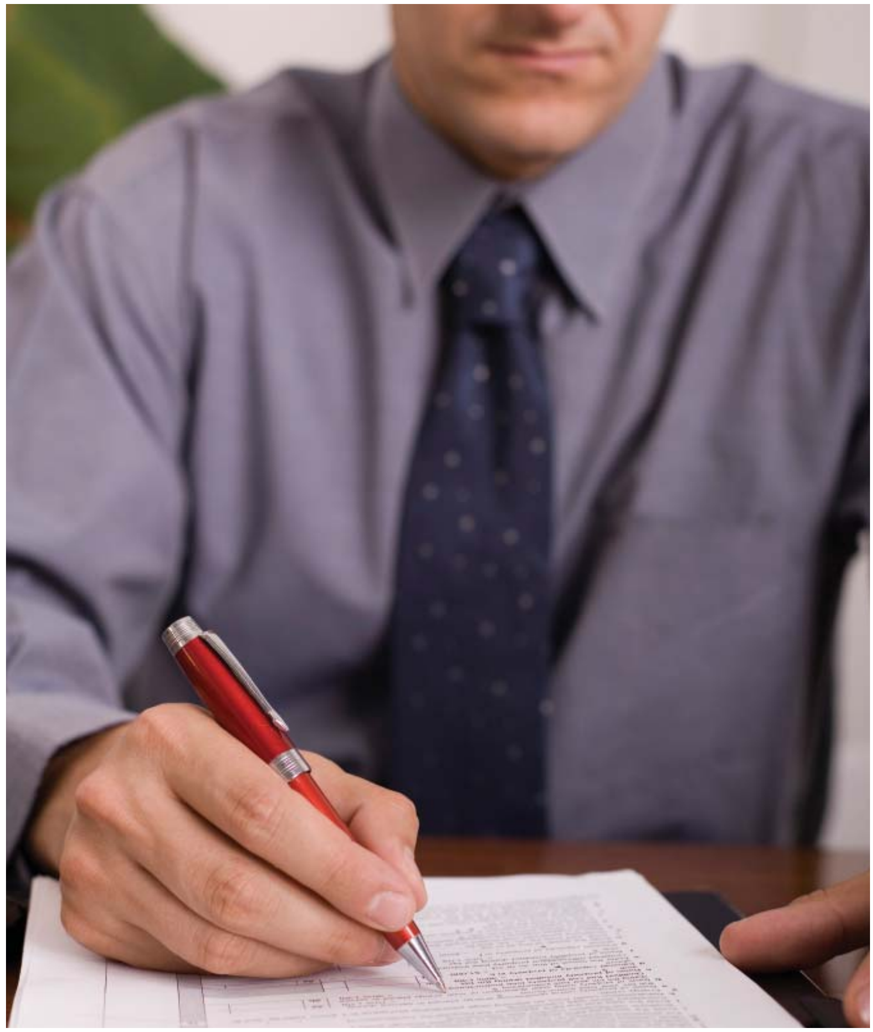
increase in the penal amount of the bond without notice to or consent from the surety, such notice and consent hereby being waived." The Virginia court sided with the obligee, noting that, although under Virginia law a surety's bond obligation may be discharged by a contract alteration that materially increases the surety's risk without the surety's knowledge or consent, the language contained in the subcontract bond form clearly demonstrated that the surety had waived in advance any discharge defense based on material alteration of the surety's obligation.



Language that limits the surety's response options

Other frequent modifications to bond language are those to reduce or to eliminate the different options available to the surety under common law to fulfill its performance bond obligations. In the event of a default, the surety's options may include financing the principal, paying a cash settlement, tendering a new contractor to the obligee or taking over the work and completing the bonded contract. The surety will investigate the claim and, based on its findings, decide on the proper course to satisfy its bond obligations. Having such options provides the surety with the ability to mitigate and to manage losses resulting from a default, lessening the impact to the project. Minimizing project losses by the surety also reduces the exposure of the principal under the indemnity it executed with the surety.

Some obligees aim at total elimination of options, essentially converting the performance bond into a "forfeiture" bond where the surety must pay the full amount of the bond penal sum in the event of a contractor default, regardless of the actual amount of the losses.

Language that significantly lengthens the time the surety remains liable

The surety's obligation under the bond is limited to the set term stated in the bond. For example, a commonly-used performance bond form, AIA Document A312, states that the obligee must bring suit on the bond within two years after contractor default, of when the contractor ceased working or of when the surety refuses to perform its bond obligations, whichever occurs first. Alternatively, a statute may set a minimum period under which the surety remains liable on the bond. In either event, such limitation periods typically cover a few years at the most, reflecting an understanding of the difficulty of and the uncertainties inherent in underwriting contract obligations that extend for longer periods of time. In other words, few, if any, surety underwriters can predict with any degree of confidence the financial strength of a company over periods extending too far into the future. Obligees may extend the time under which it may bring a claim, creating increased uncertainty and risk for the surety and contractor.

In addition to expanding the time to bring suit, obligees may expand the duration of the bond obligation. Some obligees view the surety bond as an instrument to secure a long-term

guarantee. Such modifications may take various forms, such as clear alteration of the time period stated in the bond or, in a more subtle form, such as incorporating into bond coverage a time period running to the expiration of all warranties relating to the work. This latter example might extend the bond obligation to cover such long-term warranties as roofing warranties, which may run twenty years or more.

Construction business owners should make careful review of all bond forms a fundamental part of their risk management practices. By doing so, construction business owners will be able to better avoid problematic bond language that seeks to shift risks inappropriately or that imposes obligations that they should not assume and their sureties will be reticent or unable to underwrite. ■

Mark H. McCallum is general counsel and director of government relations for the National Association of Surety Bond Producers (NASBP), Washington, DC. He can be reached at 202.686.3700 or mmccallum@nasbp.org.

Robert J. Duke is director of underwriting and assistant counsel for The Surety & Fidelity Association of America (SFAA), Washington, DC. He can be reached at 202.463.0600 or rduke@surety.org.