Surety Bonds at Work

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SURETY BONDS: SEEING PROJECTS TO COMPLETION

Construction represents about 5.0% of the U.S. Gross Domestic Product, according to the Center for Economic and Policy Research. This $1 trillion industry is composed of nearly 788,000 construction companies and 5.6 million workers. According to BizMiner, about one in five of these contractors fails.

Contract surety bonds protect the project owner against contractor failure. The performance bond assures that, in the opinion of the surety, the contractor is qualified to perform the contract. The payment bond assures that certain subcontractors, labor, and suppliers will be paid. If, despite the surety's stringent prequalification, the contractor fails, the surety completes the contract or pays for completion of the project, up to the amount of the bond.

Almost all public construction is protected by bid, performance, and payment bonds. A smaller percentage of private work is bonded. The Surety & Fidelity Association of America (SFAA) reports that sureties have paid more than $10.4 billion on contract bond claims since 1995.

Contractor failure is usually the result of multiple causes, primarily:

- Accounting & financial issues
- Management issues, which include personnel and performance
- Unrealistic growth

When a project owner declares the contractor in default, the surety investigates the situation. If it finds that the contractor has defaulted on the project under the performance bond, the surety may take one of the following actions, depending on the bond form and the specific facts of the case:

- "Take Over" responsibility for completing the remaining work. The surety hires a completion contractor.
- "Tender" a new contractor to the obligee.
- Retain the original contractor and provide trained personnel and/or financial assistance.
- Reimburse the owner by paying cost of completion, up to the penal sum of the bond.

If the investigation reveals that the contractor is not in default, the surety company is not obligated to perform.

The surety industry plays an important role in the construction industry's success. The following case studies illustrate the many ways surety companies "get the job done."

Learn More

For information on causes of contractor failure, see SIO's brochure, *Why Do Contractors Fail?*

www.sio.org

For information on the claims process, see AGC's booklet, *An Overview of the Contract Surety Bonds Claims Process*

www.sio.org

FINANCIAL ISSUES

Surety and Owner Duet—See You in September

Problem: Contractor bankrupt

Solution: Surety tenders new contractor

A North Carolina general contractor specializing in public work was well under way with the construction of a high school. The surety first learned trouble was brewing when the architect notified the surety that the project superintendent had quit. Days later, the contractor filed for Chapter 7 bankruptcy. School started in six months and there was no contingency plan if the school was not finished in time.

The county school board quickly declared the contractor in default for failing to complete the contract in a timely manner and meet milestones as stipulated in the contracts. The contract price exceeded $9 million, and at the time of the default, $4 million in contract balances remained. There were several disputed pending change orders and scope of work issues and more than $3 million in outstanding payment bond claims for labor and materials. Unpaid subcontractors had walked off the job, while other contractors slowed or stopped work.

The surety typically knows little or nothing about a project until there is a default, and in many cases, may not have the cooperation of the contractor. A cooperative owner and owner's representatives, such as the architect and engineer, are crucial. "Luckily, we were dealing with an unusually cooperative obligee, and what could have been a messy loss turned out to be one of the smoothest completion files I've worked on," the surety claims examiner said.

The surety found a mutually acceptable completing contractor, and a "Tender, Substitution, and Settlement Agreement" was executed. Thanks to the architect, who provided names of subcontractors and suppliers, the surety was able to keep them on the job with ratification agreements. And, thanks to the school board's cooperation, the surety resolved all of the payment bond claims, and the disputes between the parties over change orders, scope of work, and contract balances were fully resolved. The surety also resolved the prime contractor's delay claims. The surety paid more than $500,000 for the difference between the contract balances and the amount to complete the remaining work and assumed liability for defective work.

The high school was completed in time for fall classes.

Two Owners, Two Claims: One Happy Ending

Problem: Contractor voluntarily defaults

Solution: Surety provides temporary financing, then replaces contractor

A flexible, cooperative project owner can make all the difference in the surety claims process.

A bonded contractor had two separate $16 million projects in South Carolina with federal government agencies, each for construction of research labs, although one project was technically more difficult to build. Construction on the two projects began within weeks of each other.

Shortly after initial mobilization, the contractor became insolvent and was unable continue work. Upon meeting with the surety, the contractor agreed to voluntarily default. The surety financed the original contractor's continuing operations until it could finalize an agreement with a single replacement contractor to take over and complete both projects.

The surety then contacted both owners to deliver the voluntary default notices and set up meetings to transition the contracts. The technically difficult project, which was disrupted only 48 hours and reached completion on time and within budget, received glowing testimonials from the owner, surety, and completing contractor. In contrast, the other project owner was uncooperative and that project was plagued with delays, claims, quality issues, and end user dissatisfaction.

Problems on Unrelated Job Affect Bonded Projects

Problem: Contractor voluntarily defaults

Solution: Surety supports contractor

Faced with financial problems on an unrelated project, a contractor voluntarily defaulted on two contracts totaling $16 million to upgrade a city's wastewater treatment plant.

Although the city was satisfied with the contractor's excellent work, it turned to the contractor's surety company to remedy the problem.

The surety negotiated an agreement with the city to use a new construction company composed of the principals of the original construction company who had found new backers. Because personnel already working on the project were familiar with the contract, virtually no time was lost.

The new contractor finished the biological nutrient removal upgrade and biosolids management upgrade as scheduled.

Hotel Developer Sees Benefits of Bonding in Action

Problem: Contractor bankrupt

Solution: Surety replaces contractor

A hotel developer, taking advantage of a state loan guarantee program for tourism and recreation-related development projects, obtained performance and payment bonds on his luxury East Coast hotel. The developer soon realized the true benefits of a surety bond when the contractor filed for receivership.

The surety company quickly secured a new contractor. "I'm lucky that the bonding company took control of the project," the developer told the local newspaper. "You can see the virtue of having a bond. You never know."

The developer escaped costly delays when the surety company replaced the contractor on the $15 million hotel. Construction crews finished the hotel on time, and the upscale hotel, featuring a ballroom, three conference rooms, and a 150-seat restaurant, opened in all its grandeur.

The contractor's other projects were affected when he went bankrupt. A high school expansion project and a state employees' credit union were both bonded – and completed by the surety. Meanwhile, a bank had to take over completion of its non-bonded branch project, but refused to comment to the press on completion delays or cost overruns.

Rescue Me: Surety Assists Ailing Contractor

Problem: Contractor faces significant losses

Solution: Surety provides financial assistance

A Texas-based construction company had seemingly recovered from financial difficulties soon after its initial public offering, but faced more problems just four years later.

The contractor had significant losses on two out of five bonded contracts, citing "completion and collection" problems, and two critical clients no longer provided work the contractor said the company needed to grow.

In response, the contractor's sureties came to the rescue and provided funds to complete contracts and pay vendors through a joint control and escrow agreement with the contractor in return for an interest in the construction company.

One of the construction company owners told a reporter he was "gratified by the surety's assistance and obvious display of confidence in our experienced construction team."

Live by Change Order, Die by Change Order

Problem: Contractor experiences cash flow problems

Solution: Surety assists contractor

Contractors who fail to negotiate change orders or be paid in a timely fashion for the extra work can suffer crippling cash flow problems.

When one mechanical general contractor performed extra work equivalent to a fourth of the original contract without getting paid, the contractor faced significant cash flow challenges that affected his bonded and non-bonded projects. The surety company reviewed the status of all of the contractor's projects when subcontractors filed payment bond claims.

After analyzing contract balances, accounts payable, estimated completion costs, and other issues likely to affect those amounts, such as defective work or liquidated damages, the surety decided to finance a zero-balance trust account managed by a surety consultant and construction management services firm. Obligees sent payments to the firm for deposit into the trust account.

The consulting firm, contractor, surety, and claimants resolved payment bond claims, and the contractor and project owner successfully mediated the disputed change orders. Finally, the contractor used the settlement proceeds to bring accounts payable current and satisfy its indemnity obligations.

What, Me Worry? Condo Project Owner Doesn't Fret Work Stoppage

Problem: Contractor abandons job

Solution: Surety replaces contractor

The contractor, in business for 52 years, abandoned work on a 25-story condominium tower in North Carolina just days before the scheduled completion date. Work was 80% complete and subcontractors were leaving the site. The developer, however, didn't lose any sleep over it. He had bonded the $48 million project, and was confident the building would be completed.

"The bonding company may have to hire a totally new contractor to finish the building, and it could take a couple of weeks to do that," the developer told the local newspaper. "They'll make sure it's finished right."

The contractor attributed its financial troubles to recession-related problems, not the condo project, and earlier laid off some employees and closed an office as part of a downsizing effort. "We're like everybody else," the company's chairman told the newspaper. "The number of jobs is down, and so is the number of jobs coming on the market. Since 9/11 a lot of projects have been put on the shelf."

The surety company replaced the contractor with a new construction company. "It's a

challenging opportunity and high-profile project," the new contractor told the newspaper. "I know we have the expertise and the right project team to bring the project to a satisfying conclusion."

The developer told condo buyers that, thanks to the surety company and new contractor, the 115-unit, 450,000-square-foot building would be "an even better and more beautiful home for each of you."

Surety Quenches County's Thirst for New Pipeline

Problem: Contractor abandons job

Solution: Surety replaces contractor

A $25 million water pipeline project that dried up for six months after the contractor abandoned the job site was still completed on time and within budget, thanks to the efforts of the surety company and the replacement contractor.

The surety company assumed responsibility of the project after the contractor went bankrupt. Apparently, the contractor also walked off 20 other project sites throughout the country.

Despite the delay, the project's owners celebrated its completion. The 4.7-mile pipeline connected a reservoir to a county treatment plant and doubled the volume of water supplied to the 500,000 residents in the Southern California county.

Surety Completes Highway to Tune of $16 Million

Problem: Owner declares contractor in default

Solution: Surety completes on time

Even well-established contractors can hit a sour note. The magnitude of one heavy/highway contractor's financial problems was revealed soon after a turnpike commission declared the contractor in default on a major highway project that was nearly 65% complete when the contractor stopped work in January 2006 after 22 months on the job.

The contractor, who was known for handling multimillion dollar road and airport construction projects, was the lowest bidder by $6 million on the $45.9 million, 2.4-mile portion of the roadway project. Change orders increased costs to $47 million. Completion was scheduled for fall 2006.

In February, the commission declared the contractor in default. By May, the contractor filed for Chapter 7 liquidation, listing 500 creditors, $55.3 million in liabilities, and $2.7 million in assets. The contractor also had stopped work on two other highway projects in another state.

The defaulted contractor's surety company quickly took over and awarded the remainder of the highway contract, about $16 million, to a contractor who was already on the job.

By October, the turnpike commission held a grand opening, complete with an orchestra, for the new highway, which cuts 20 minutes off motorists' drive to the airport. Now that's music to commuters' ears.

OVEREXTENDED CONTRACTOR

Bridge Over Troubled Waters: Owner Cooperation Key to Smooth Contractor Replacement

Problem: Overextended contractor

Solution: Surety replaces contractor

An overextended contractor on a $2.8 million bridge project removed its crews from the site in September—80% of the way through the project—yet the county waited an untimely eight months later, the following May, to declare the contractor in default.

Nearby residents were extremely frustrated with the delay and pressured the county to finish the project. One resident traveled 20 miles to visit his son who lived one-half mile across the river. A small business owner lost revenue because of the bridge closure.

Once default was declared, the surety wasted no time in assuming control of the project. "They are moving in an expeditious manner," the county engineer told a local newspaper. "It's in the best interests of the bonding [company] to get that bridge completed quickly."

The surety hired a replacement contractor, who finished the job in 75 working days. Work included minor construction and clean up on a small bridge; paving; a main span, railings, and other work on the main bridge; and corrective work on both bridges. The surety absorbed the costs in excess of the half million dollars remaining in the contract.

With the exception of the untimely default declaration, the county's cooperation helped assure a smooth transition of contractors, and its assistance in supplying the surety with needed information were keys in getting the project up and running again.

The original contractor had overextended when it took on several large projects in a short time, and ended up defaulting on at least two other bridge projects.

The Advantage of a Solid Surety Relationship

Problem: Overextended contractor

Solution: Surety offers financial assistance

A large, privately owned and established general contractor incurred an $11 million loss over two years on a $60 million hotel project, resulting in the firm's financial collapse and jeopardizing six other bonded projects—ranging from $6 million to $15 million—in various stages of completion. There was potential for massive liquidated

damages to the surety and actual loss of revenue to the owners in the event of project delays.

The general contractor had demonstrated a history of healthy profits and had no prior claim activity with the surety. The surety determined that the contractor's financial problems were not related to its performance. In fact, all the project owners were satisfied with the timeliness and quality of work. Furthermore, key contractor personnel were willing to stay on all the projects through their completion.

The surety claims team looked at options for getting all projects finished on time. If the projects were to be rebid with a new contractor and possibly new subcontractors performing the work, they would have faced substantial relet costs and potential delays. These in turn would have likely resulted in significant delay damages. The surety determined that a combination of limited financing and relet were appropriate.

The surety provided financial assistance to enable the general contractor to stay on and complete all but one project. The surety met with subcontractors and suppliers to resolve all open project payables, bonded off or resolved all project liens, met payroll and overhead needs, and controlled receipt and disbursement of contract receivables.

With the seventh owner's involvement, the surety hired a completing contractor to finish the largest and least complete project for a fixed fee with an assignment of remaining contract funds. Together, the surety and owner developed the scope of work to complete. The owner also released earned but unpaid funds to the surety, which was then able to pay outstanding direct job costs rather than withholding those funds for potential liquidated/actual damages for delays. The owner's cooperation and involvement paved the way to the successful solution.

Projects were turned over to all seven owners lien free and on time. The surety paid $8.7 million on the seven jobs. Consider this: the maximum bond premium on all seven jobs would not exceed $2 million. Had there been no performance and payment bonds, who knows what the cost in time, money, and aspirin would have been to the owners.

PERFORMANCE ISSUES

Seeking to Avoid Backups of Another Kind, City Terminates Slow Sewer Contractor

Problem: Contractor behind schedule

Solution: Surety replaces contractor

The sewer line project was already months behind schedule, so when work slowed to a creep, the suburban community cried foul.

While it was satisfied with the quality of work, the town was unhappy about the contractor's pace in completing the $400,000 project, which was intended to ease sewage backups in several neighborhoods. “They’ve had limited personnel out there in the past two weeks,” a city public works official complained to the local newspaper.

The town declared the contractor in default about a fourth of the way into the job, and the surety company assumed control of the project and hired a new contractor to finished the project. “This is an example of why we need bonds—anything can happen, even to a good company,” an elected city official told the paper.

On Your Mark, Get Set, Go! University Track Completed Just in Time

Problem: Owner defaults contractor

Solution: Surety rebids contract, new qualified contractor completes on time

A general contractor hired to build a college track and field was disqualified for failing to construct the track in accordance with NCAA guidelines. As track season quickly approached, the university defaulted the contractor. The surety company, teamed with a surety consultant and construction management services firm, earned a gold medal for locating qualified contractors familiar with the specialized track materials, rebidding the project, and completing the work in record time.

The Perfect Storm

Problem: Financial, management, and overextension issues

Solution: Surety completes bonded projects

One construction company, in business for nearly 50 years, overextended itself, had financial difficulties, and experienced management issues. As one of the oldest family-owned businesses in the area, this well-known and well-respected company had built some of the most distinctive buildings in the area. Twenty years ago, the company employed 300 people and had revenues of $300 million. The company was run by the founder’s two sons, who 10 years ago had a falling out. One son remained with the business; the other established a competing construction company.

The company then entered an aggressive condo market and underestimated the risks and competition involved. At the same time, a key employee departed. The company was unable to pay subcontractors and turned to its surety.

The surety paid the subcontractors and found completing contractors for two bonded condominium projects. A third condo project was not bonded. The developer on that project said, “It will cost us a lot more to finish up [the project] than the money left in the contract.”

WRONGFUL DECLARATION OF DEFAULT

Wrongful Termination Proves Costly, But Surety Completes Project

Problem: Owner wrongfully defaulted contractor

Solution: Surety completed job w/new contractor, court settlement 13 years later

A city declared its contractor in default when a $25 million parking garage was 80% complete. Despite the contractor's claim that the termination was wrongful, the surety hired a new contractor to finish the project at a cost of $12 million. The original contractor sued the city for wrongful dismissal and won a $41 million judgment, which was finally settled 13 years after the initial claim. The city, having lost two appeals, did not appeal the decision further. The Court of Appeals found evidence that the city dismissed the contractor because city officials did not have enough money to complete the garage.

The city paid the contractor $18.4 million for unpaid fees and interest. The surety recovered its $12 million plus 14 years of interest.

NO BOND/INVALID BOND

Before a project owner accepts a surety bond, it is important to verify that it is from a reputable surety company. Most large property and casualty insurance companies have surety departments. In addition, there are some insurance companies for which surety bonds make up all or most of their business. In either case, in order for a company to write a surety bond in the United States, it must be licensed by the insurance department of one or more states in which the surety conducts business.

School Board Learns Lesson on Validating Surety Bonds

Problem: Contractor's bonds not valid

Solution: Owner discovers bond is invalid and cancels contract, has to rebid project

Just days before work was to begin on the second phase of a major elementary school remodeling project, a school board canceled the contract when the contractor failed to prove it had obtained valid performance and payment bonds. The contractor had successfully completed the first phase of the project, but failed to respond to the district's request to prove the required bond was in place to begin the second phase. An investigation revealed that the surety bonds presented to the school district were not issued by the surety company named on the documents.

Although the board's decision would mean that the remodeling project was delayed until the following summer to allow the district to find a new builder, "it could have been worse, if we had to stop construction and find another means to finish the work," a district official told the local newspaper. "This way we were able to mitigate the impact on costs and students." However, the school district may be liable to subcontractors, many of which had already purchased supplies and hired employees in anticipation of starting work immediately.

The construction company may have forged bonds on other construction projects—including a $3.1 million fire station and two projects for a port authority. When the city's project manager for the fire station called the bonding company to discuss some minor problems with the contractor, he learned the surety had not issued the bond, the employee named as the surety company's agent was a forgery, and the notary did not exist. The city halted construction and began the process of rebidding the project. The port authority's 12,000-square-foot building was complete and a $2.1 million maintenance hangar was almost complete. The port authority let the contractor finish the job but took steps to assure subcontractors were paid.

School District Gets an 'F' for Failing to Verify Contractor's Bond

Problem: Contractor does not provide bond to owner

Solution: None. Problem costs owner time, money, and lawsuit

A Southern California school district's failure to ensure that a construction company was properly bonded on construction of three new schools and remodeling on other school projects may prove to be a costly mistake.

The school district did stipulate that the contractor obtain surety bonds, but no one verified that the contractor actually obtained the bonds before work began. "Somebody did not make sure the i's were dotted and the t's were crossed," an executive at the local contractors' association told the community newspaper.

Subsequently, at least a dozen subcontractors were not paid when the contractor ran into financial trouble and went out of business, and the district may bear the burden—more than $500,000. Ultimately, the courts will decide, as some subcontractors seeking payment have filed civil lawsuits against the district and the contractor for breach of contract and negligence.

Law enforcement officials are investigating the contractor for possible criminal wrongdoing. What's more, the district was required to hire a new contractor to complete unfinished work on

the school projects and faced at least three months' delay. Had the contractor properly secured a surety bond as it was required to do, the surety company would have been responsible for paying the subcontractors and completing the projects.

Unpaid Subcontractors Lands City in Quagmire

Problem: Contractor does not provide bond to owner

Solution: None. Problem costs owner time, money, and lawsuit

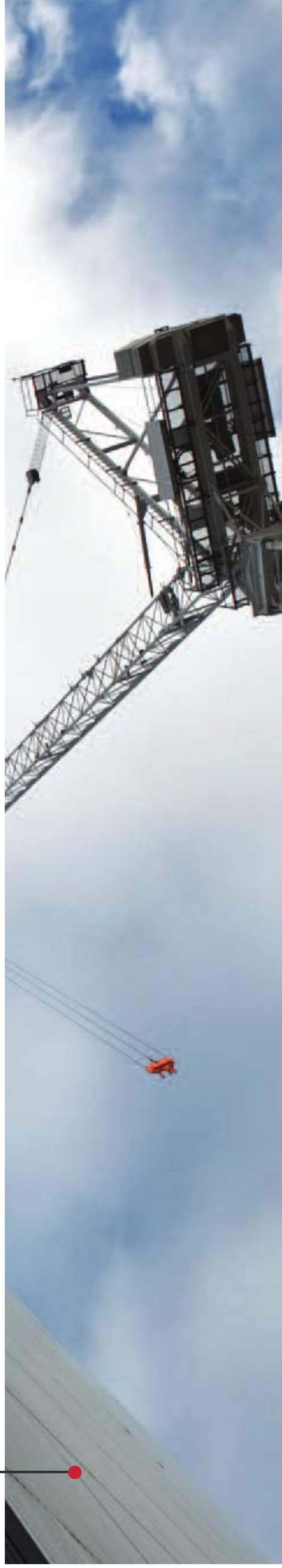
As summer drew to a close, the only thing on the minds of swimmers in one small Midwestern town was that the public swimming pool was closing and school was starting. Lawyers for the city and for subcontractors who helped build the $2.1 million pool had other things on their minds.

They were heading to court because the city and the architect approved the deletion of the performance and payment bond requirement from the contract.

The city paid the general contractor, and the general contractor paid its subcontractor, a pool company. But the pool company failed to pay its four subcontractors. While the city met its financial obligations, failing to require a payment bond in an attempt to reduce construction costs may prove a costly decision.

The City Council was expected to deny three tort claims totaling almost $50,000, forcing the three subcontractors to file civil suits and join a fourth who already withdrew its tort claim and filed a $30,000 civil suit. The city responded by filing an $80,000 negligence suit against the pool's architect, but a judge dismissed the city's suit, ruling that failing to require the bond led to the liability facing the city and county.

NOTES



Surety Information Office (SIO)

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The Surety Information Office (SIO), formed in 1993, disseminates information about the benefits of contract and other forms of surety bonding in private and public construction. SIO, a virtual office, is supported by the National Association of Surety Bond Producers (NASBP), www.nasbp.org, and The Surety & Fidelity Association of America (SFAA), www.surety.org. For information on the benefits of surety bonds in construction and in other contexts, contact the Surety Information Office at sio@sio.org.

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The National Association of Surety Bond Producers (NASBP), founded in 1942, is the association of and resource for surety bond producers and allied professionals. NASBP producers specialize in providing surety bonds for construction contracts and other purposes to companies and individuals needing the assurance offered by surety bonds. NASBP producers engage in contract and commercial surety production throughout the U.S., Puerto Rico, Guam, and a number of countries. They have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.

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