

Managing the Risk of Subcontractor Defaults

Subcontract Bonds and Other Alternatives

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When a general contractor enters into a construction contract with an owner, it explicitly assumes the risk of timely and complete performance of the work. It will often furnish bonds guaranteeing that performance. The general contractor may then subcontract a substantial percentage¹ of the work to various subcontractors in the particular trades. The success or failure, and the profit or loss, on a project may ultimately depend on whether those subcontractors timely and properly perform their work. Some don't. Some fail.

Most general contractors have developed practices and procedures to screen out unqualified subcontractors, monitor subcontractor performance, and protect against subcontractor failure. Some of the common practices used by general contractors are worth noting:

- Prequalification of subcontractors, through reference checking and select bid lists
- Caution when dealing with high percentage bid spreads
- Verification of subcontract scope
- Use of well written subcontracts and purchase orders
- Requirements for adequate insurance coverages
- Monitoring of payments to the subcontractors' vendors through periodic lien releases, joint checks, and bills paid affidavits
- Contractual retainage on progress payments
- Good safety programs
- Attention to draw schedules of values to avoid unbalanced or front end loaded payment terms
- Management of the subcontract draw process through careful evaluation of progress, percentage of completion, and remaining cost to complete

¹ The percentage of subcontracting varies by company and type of work. A utility contractor may self perform all of its work, subcontracting nothing. A typical commercial building contractor is likely to subcontract 80% or more of the work on a project, perhaps everything other than project management.

- Management and supervision of subcontractors in the field
- Schedule control
- Sensitivity to signs of subcontractor failure and a commitment to deal with or avoid it before it impacts a project

These are risk minimization/avoidance practices and procedures that can be employed by the general contractor with its own personnel. In addition, there are several risk transfer/risk minimization products and services available through third parties to further protect against the consequences of subcontractor failure. This paper will focus on two risk transfer products and two third party risk management services that are available to general contractors. The products, underwritten by insurance companies, are subcontract bonds and subcontractor default insurance ("SDI"). The services, provided by accountants, consultants, and third party providers are outsourced subcontractor prequalification and services variously called "third party funds control," "funds disbursement," "funds administration," or "construction escrow services."²

Subcontract Bonds

The bonding of subcontracts has become an increasingly common practice in the commercial construction industry. In many cases, sureties are requiring their general contractor clients to require bonds from major subcontractors. Many general contractors simply consider it prudent business policy to bond all subcontracts above a threshold dollar value. With increasing frequency, owners and developers are requiring that major subcontracts be bonded, so as to assure higher quality of construction, whether or not the general contractor is bonded.

The results of surveys conducted by the American Subcontractors Association demonstrate that subcontract bonding is virtually a fact of life in the commercial construction industry. In one survey, eighty percent of the responding specialty trade

² Disclosure: I have tried to be unbiased and objective in the comparison of those two products. While I am an officer in a surety company, and obviously believe in the value of surety bonds, I am also the President of a company that provides fee-based services to Subcontractor Default Insurance users. I also think SDI is a fine product. Each of these provides a risk management tool. Each has its unique attributes. There is room for both in the general contractors' tool chest of risk management products. The other two services covered in this paper, funds disbursement services and subcontractor prequalification, are natural add-ons to Subcontractor Default Insurance, or to any subcontract risk management program. SureTec provides those services. The references in this paper to SureTec's services are merely those with which I am most familiar and believe to be representative of the services available in the market. There are many other well qualified companies who also provide similar services. My goal is to educate construction lawyers on the availability of these services and not to solicit anyone's business or promote our services over those provided by many other service providers. I sincerely hope the presentation is received accordingly.

contractors stated that they had provided surety bonds as subcontractors on projects.³

When a contract is "bonded," the subcontractor, as principal, and a corporate surety, as surety, obligate themselves to a general contractor, guaranteeing that an underlying construction contract will be performed as set out in that subcontract. A "subcontract performance bond" provides assurance to the general contractor that the contract will be completed for the agreed-upon contract sum, while the laborers, materialmen and subcontractors of the contractor or subcontractor look to the "payment bond" for assurance that their request for payment will be satisfied.

Subcontract bonds are typically written for 100% of the subcontract amounts...coverage equal to 100% of the subcontract amount for the performance obligations and coverage equal to 100% of the subcontract amount for the payment obligations. Both bonds provide "first dollar coverage;" i.e., do not have deductibles or co-pay provisions.

The premium for performance bonds will depend on the nature of the work, length of the project, and the financial strength of the subcontractor. Rates of 1% to 2 ½% are common, with 1 ½ % as a common rate used by estimators in projecting the costs of subcontract bonds for a project. Because a sliding scale is used, the premiums for smaller bonds are greater, often toward the 2 ½% end of the range, with larger bonds averaging out to 1% or less. There is usually no additional premium for the payment bond. A payment bond alone is slightly less than the premium for a performance bond or performance and payment bond. Bid bonds usually are issued with no charge or only a minimal charge. Premiums are generally surcharged at a slightly higher rate for design-build subcontracts and projects of greater than two year duration.

By bonding its subcontractor, the general's own credit standing with his surety will be improved due to the transfer of the risks to the subcontractor's surety.

The ability of a subcontractor to furnish bonds is a form of prequalification. In order for the subcontractor to provide those bonds, it will have gone through the surety's reference checking and financial review. By virtue of the indemnity agreement typically executed by the owners of the subcontracting firm in favor of the subcontract surety, the general contractor gains assurance that the individual owners of the subcontracting firm will stand behind their company, if necessary, with their personal assets.

The bonds themselves are usually written on the same types of bond forms that may be furnished at the general contractor-owner level, with one key difference. In most states the rights and liabilities of the parties to payment bonds furnished by a general or prime contract are, to a great extent, determined by statute.⁴ These

³ American Subcontractors Association, Survey of Construction Subcontractors on Experience with Surety Bonding (July 1988).

statutes prescribe various notice requirements, statutes of limitation, and the form and manner in which claims may be made against the bond furnished to the owner by the general contractor. Where the general contractor's bond is governed by one or more of these statutes, the actual content of the bond form tends to become less significant, since the bond may be held to incorporate the terms of a statute pursuant to which it is written.

In contrast to those bonds that are statutorily prescribed, subcontract bonds are simply common law obligations subject to general rules of contract law and construction.⁵ This absence of statutory regulation results in a wide variation in the types of bonds required of, or provided by, subcontractors and their sureties. The particular bond form that is employed will substantially affect the allocation of risk between the general contractor/obligee, the surety, and the subcontractor/principal.

The rights and liabilities of the obligee or other claimants under a bond will be determined in accordance with the written terms of that bond, and often in the surety's favor, under the rule of interpretation referred to as strictissimi juris.⁶ This rule of interpretation, though somewhat weakened in recent years, is still applied in Texas.

There are several types of bond forms encountered in subcontract bonding transactions. These forms include separate payment and performance bonds, and combined payment and performance bonds. Whether separate or combined, the forms of payment bond further fall into two categories; those that provide direct action to third party claimants and those which indemnify only the named obligee. They are as varied in terms and content as the imaginations and drafting skills of the general contractors who require them and the sureties who execute them. While it would be simple enough to suggest that separate bonds always be used, and that the payment bond always be written with the suppliers as intended obligees, there are occasions

⁴ For example, in Texas, bonds furnished by prime contractors on state, local and other non-federal public works are required by, and governed by Chapter 2253 of the Government Code. Bonds furnished by prime contractors on federal projects are governed by the Miller Act, 40 U.S.C. § 3131 et. seq. In Texas, there is no statutory requirement that prime or "original" contractors on private construction projects furnish bonds, but those payment bonds that are furnished will generally be governed by Subchapter I of Chapter 53 of the Property Code.

⁵ In Anahuac v. Wilkes, 622 S.W.2d 634 (Tex. Civ. App.-- Austin, 1981 no writ), the court held that a subcontract bond was not governed by the Texas private works bond statutes. In that case, the claimants on the payment bond had perfected their claims in accordance with the terms of a bond which apparently contained more liberal terms than the requirements of the Property Code. The surety argued that the notice and filing requirements of the Act should govern. The court rejected this argument, stating that the bond did not appear to have been posted in compliance with the private works bond statute, so that the terms of the payment bond governed, and the surety was obligated to pay the claims.

⁶ See, Colonial American Cas. & Sur. Co. v. Scherer,--- S.W.3d ----, (2007 WL 135969 Tex. Civ. App.-Austin, 2007. January 19, 2007), New Amsterdam Cas. Co. v. Bettles, 407 S.W.2d 307 (Tex. Civ. App. – Dallas, 1966)

when more restrictive bond forms are appropriate. The following discussion will guide you through some of the issued to be encountered.

Separate Payment and Performance Bonds

The issuance of two separate bonds, one to guarantee the subcontractor's performance obligations, and one to guarantee the payment by the subcontractor of its sub-subcontractors and suppliers, is perhaps the most frequently encountered method to bond subcontracts. Likewise, it is the most frequently encountered method in the general contractor bonding context. Separate payment and performance bonds maximize coverage for both the obligee-general contractor, as well as third-party claimants since they provide two penal sums, i.e. two separate funds for recovery. The general contractor-obligee looks to the performance bond, and usually, third-party subcontractors and suppliers look to the payment bond. AIA Documents A-311 (1970 version) and A-312 (1984 version), and surety department variations thereof, are often used as separate subcontract performance and payment bonds. Many general contractors require subcontract bonds to be issued on forms developed by the general contractors. Those tend, obviously, to favor the general contractor. Many sureties use their own forms, which tend to restrict some of the coverages provided. The practice pointer: Read the bonds you are providing or receiving.⁷

Combined Payment and Performance Bonds

Payment and performance bonds may be combined in a single instrument. However, as stated above, it is usually to the general contractor's advantage to require separate performance and payment bonds in order to assure protection for the general contractor and creditors sufficient to complete performance and pay unpaid subcontractors or suppliers in the event of default. Separate payment and performance bonds eliminate the problem of deciding who should be paid first, i.e.

⁷ A tremendous amount of attention is paid, by general contractors and subcontractors, to the terms of subcontract documents. Seldom is any attention paid to the subcontract bonds. General contractors should understand that available bond coverages vary, and often for very good underwriting reasons. A particular subcontractor may qualify for a \$1 million roofing subcontract bond, but not if the subcontractor's liability is co-extensive with the roofing material supplier's 20 year roof warranty...thus a contractual limitation provision in the bond to perhaps two years. If the general contractor holds to requiring a bond form with no limitation, it loses the bid of that roofer. The question becomes...."Did we really need the roofer to be jointly liable with a Fortune 1000 material supplier on a membrane warranty for years 3-20? Was blindly adhering to our requirement of no time limitation in the bond really worth the difference in the next higher price that we had to pay?" Of course, if having the bond protection for the longer period is important, the general contractor should look for a subcontractor that can qualify for such bond credit. Subcontractors also ought to consider whether they are signing bonds that have obligations that are greater than what they have negotiated in their subcontracts. A good example is a provision in a general promulgated bond form that says that the surety's obligation is triggered by "a breach" rather than a properly declared default termination. I've seen subcontractors negotiate extensively for better default clauses and longer cure periods, only to give it all away in a loosely written subcontract bond. Bond forms are as important as the underlying subcontracts and should be treated as such in subcontract drafting and negotiations.

the obligee or the claimant, by providing two penal sums. The general rule is that where the payment and performance obligations of the surety are combined in a single bond, the performance obligation may take priority and a third-party claimant, in some situations, may not be able to maintain a separate suit on the bond.⁸ An obligee who is being provided with this type of bond form should review it carefully and, if possible, insist on a separate payment and performance bond to more adequately protect its rights.

Indemnity Bonds

Under this bond form (which may be in the form of a separate payment bond form, or in a combined form), unpaid suppliers and sub-subcontractors of the bonded subcontractor have no direct claim against the subcontractor's surety. Instead, these claimants are relegated to filing their claims against the general contractor, its bonding company and/or the owner under the Miller Act or applicable state law. The obligation of the subcontractor's surety is limited to "indemnifying" or "paying back" the general contractor only for such losses as the general contractor may sustain by virtue of those claims. Liability to third parties, other than the named obligee, is usually expressly excluded.

When a subcontract indemnity bond is compared with the typical performance bond, such as the AIA performance bond, it is obvious that the performance exposure of the subcontract bond surety under an indemnity bond is relatively limited in certain respects. Under the AIA performance bond, the surety is obligated to remedy its principal's default or otherwise arrange for the completion of its principal's work. Although the general contractor would prefer this bond in the event of its subcontractor's default, there are circumstances where a subcontractor may only be able to qualify for the somewhat more restrictive indemnity bond.

Advantage of Subcontract Bonding to the Subcontractor

The subcontractor who has the ability to bond sets itself apart as a pre-qualified participant in the construction process. The availability of bond credit shows the general contractor that the subcontractor has been judged by third party underwriters to have the character, capacity and capital to perform its subcontract obligations. The ability to pre-qualify has competitive advantages for the subcontractor.

Additionally, the bonded subcontractor may be given greater leeway in billing, have less retainage withheld, and may be subjected to far less paperwork with respect to proof of payment to lower tier subcontractors and suppliers.

⁸ See, *Daniel-Morris Company, Inc. v. Glens Falls Indemnity Company*, 126 N.E.2d 750 (N.Y. 1955).

Subcontractors benefit, in terms of fewer schedule disruptions and claims, from working alongside other qualified bondable subcontractors.

Advantage of Subcontract Bonding to the Project Owner

While the project owner may be protected against the general contractor's financial failure by the general contractor's bonds, any project is enhanced when all of the participants are pre-qualified, financially stable, and backed by corporate sureties. Quality, safety, schedule adherence, and performance during contractual warranty periods are all enhanced.

Advantages of Subcontract Bonding to General Contractors

Most of the advantage of subcontract bonding are obvious: professional third party prequalification of subcontractors, first dollar coverage against loss, coverage equal to 200% of the subcontract amount, the surety's claim services, and a place to point unpaid suppliers when they come knocking on the general contractor's door for payment. One of the most significant advantages of subcontract bonding, not often appreciated, is that most subcontractors' individual owners have to personally guarantee to their sureties that the work will be performed and bills paid. Occasionally, they will post collateral or have the indemnity of third parties as well. The fact that the individual owners are personally committed will usually insure that bonded jobs are taken care of before unbonded jobs, that bills on bonded jobs are paid before bills on unbonded jobs, and that the individual owners have a vested interest in favoring the bonded project over all others.

Dual Obligatee Riders

As its name implies, a dual obligee rider is an attachment to a bond which designates a second obligee as a beneficiary under it. By naming a dual obligee, the surety assumes an additional obligation to a separate entity which is not a party to the bonded subcontract, but which has an interest in the project. These types of riders are occasionally required by project owners who want the protection of the subcontract bonds in the event of a general contractor default.

As may be expected, the addition of the owner as an obligee under a subcontract bond creates a new set of risks and complexities for the parties involved. The obvious disadvantage for the subcontractor-principal is that the subcontractor now has another party with a potential remedy against him in the event that party becomes dissatisfied with the subcontractor's performance. Depending upon the language of the rider, the subcontractor may have assumed obligations to the owner despite the fact that the owner is not a party to the subcontract. Thus, the subcontractor may lose the "buffer" of the general contractor, who, in the normal situation, would stand between the disgruntled owner and the subcontractor in the usual chain of relationships on a construction project. Worse yet, and absent

appropriate savings language, the subcontractor and its surety may find themselves obligated to an owner notwithstanding a breach of contract by the general contractor.

Occasionally, a general contractor may attempt to bond all of its subcontractors, name the owner as dual obligee, and in that manner satisfy its own bonding requirements under the general contract. Assuming that each respective subcontractor's surety would agree to such an arrangement,⁹ and that the owner would accept such arrangement,¹⁰ numerous problems can still occur. For example, this type of arrangement may run afoul of the requirements of a state public works act which requires that the general contractor itself provide performance and payment bonds. The stacking of subcontract bonds in this fashion would not, for example, satisfy the statutory payment bond requirements of either Chapter 2253 of the Government Code or Chapter 53 of the Texas Property Code.

Subcontractor Default Insurance ("SDI")¹¹

Subcontractor Default Insurance ("SDI") is an insurance policy that provides coverage to general contractors for the direct and indirect costs of subcontractor defaults. Some general contractors use SDI in lieu of requiring bonds from subcontractors. Some general contractors use both SDI and bonds as risk shifting tools. With high deductibles and co-pay provisions, SDI is not "first dollar" coverage for subcontractor defaults. Rather, it is a type of self insurance which provides catastrophic coverage for subcontractor defaults. It is generally not sold to contractors with annual volumes of less than \$50 million. It is a product best suited to large contractors with proven discipline in their careful selection and management of their subcontract risks.

Subcontractor Default Insurance was first introduced in the mid 1990's. As of the date this paper was prepared, Zurich North America is the only issuer of SDI, although competition by other insurers for the SDI market may develop as SDI develops a track record. Zurich's policy is known as "Subguard. ®" At least one other major insurance company has issued SDI, but is not in the market now.

An increasing number of large general contractors, construction managers and design build firms have purchased SDI. While hard data on the utilization of SDI is

⁹ Sureties are reluctant to bond subcontractors to unbonded prime contractors. Cynics will suggest that the reason is that those sureties would generally like to see more premiums generated. On the contrary, the subcontractor working for an unbonded general contractor has assumed a credit risk. If the general contractor were to default and fail to pay the bonded subcontractor, the subcontractor or its surety would be required, at a minimum, to pay that subcontractor's suppliers for work performed . . . and without compensation.

¹⁰ That still leaves the general contractor's obligations unbonded and the potential for all of those subcontractors and their sureties not to be liable if the general contractor defaults and does not pay them.

¹¹ Many thanks to Steve Warnick of Austin Commercial, LP, a user of both subcontract bonds and SDI, for his help with this aspect of this paper.

not generally available, the author believes that at least seven of the ten largest commercial building contractors in Texas are using Subguard on some or all of their projects. It is speculated that, based on volume of contract exposure covered, SDI's underwriter, if it were a surety, would rank in the top three or four surety underwriters in the country. While once considered by some critiques in the competing surety industry as a "flawed product" which would not last, SDI has gained traction and considerable acceptance among the largest contractors in the U.S. As such, it is a product that construction law practitioners should know something about.

Coverage and Terms

SDI is written on a surplus lines basis. Policy limits and deductibles will vary from policy to policy based on the general contractor's risk appetite. Policy terms are occasionally negotiated by the sophisticated general contractors that purchase it. Thus, it is hard to make too many generalizations about its coverage policy terms. Anyone interested in purchasing it would be well advised to use an insurance broker who is very familiar with the product. Any practitioner involved in negotiating or interpreting policy terms should refer to the policy itself. Those caveats aside, the following are the policy terms most often encountered:

- SDI is first party insurance indemnification form. That is, it is purchased by the general contractor. The general contractor is the insured.
- SDI is a two party agreement between the general contractor and the insurance company. The subcontractors are not party to the agreement.
- The project owner can, by endorsement, be named as a scheduled entity to a financial interest (loss payee) endorsement.
- The policy is triggered by a subcontractor default in accordance with the subcontract terms. If it is determined that the default was improper, coverage would cease and payments previously made by the carrier would have to be returned.
- The general contractor is required to prove a default through the filing of a "proof of loss." The SDI carrier is obligated to indemnify the general contractor for a loss within thirty days after the carrier receives a properly documented proof of loss.
- The SDI carrier has no "duty to defend" in this contract of indemnification.
- All unbonded subcontractors on a project are typically covered. Purchase orders can also be covered by agreement. Thus, the general contractor is responsible for subcontractor prequalification. The insurance company does not prequalify the subcontractors. In essences, it prequalifies the general contractor's prequalification process.

- SDI covers the expenses incurred by the general contractor in fulfilling a defaulting subcontractor's obligations, the cost of correcting defective or non-conforming work, professional costs incurred as a result of the default, and indirect costs associated with subcontractor default, such as delay damages, acceleration costs of a critical path subcontractor that is adversely impacted by the defaulted subcontractor, and extended overhead costs incurred by the general contractor (which are considered an indirect expense and subject to a sub-limit).
- Both performance and payment related costs, including the cost of removing liens is included. The policy does not, however, provide direct payment coverage to the subcontractor's suppliers and sub-subcontractors. In this respect, it is like the indemnity bond discussed above.
- Coverage does not cease at policy expiration. The SDI policy will generally respond through the statute of repose or ten years, whichever is earlier. It is not a claims made policy. The policy year in which the subcontract is executed dictates the year in which a default is covered.
- For coverage to be effected a subcontractor must be given a formal written notice of default in accordance with the subcontract terms, but the subcontractor does not necessarily have to be terminated.
- There are nine exclusions based on misrepresentation, fraud (including the filing of a false claim), defaults occurring prior to the policy period, material breach of warranty by the general contractor, subcontracts acquired from other entities, nuclear risks, war risks, losses arising out of the providing of professional services by the insured, and loss resulting directly or indirectly in bodily injury.
- Losses which exceed deductibles are pursued in subrogation by the SDI carrier. If any recovery is made, the insurance company is made whole first. Any recovery after that will be shared with the general contractor as outlined in applicable terms of the policy.
- Existing subcontract balances must be exhausted before the indemnification can take place.
- Generally written as separate annual policies in a three year program.
- Subject to a deductible per default of \$500,000 (although that amount may be negotiated up or down depending on the structure and size of the program and the general contractor's appetite for risk). The SDI underwriter definitely wants the general contractor to have "skin in the game,"

- Subject to a co-pay of 20% of a specified layer over the deductible...to keep the skin in the game.
- Written with varying one year and three year aggregate limits, but generally not available for more than what a general contractor is willing to assume and remain in business due to a catastrophic loss or aggregation of losses in an annual policy period. Generally not available for more than \$50 million per default and \$100 million in the aggregate for all losses in a given year. This is significant when compared to the coverages of subcontract bonds. Subcontract bonds provide coverage equal to 200% of the subcontract amount (performance and payment bond coverage) for each subcontract. On a \$50 million project that is 80% bonded, that's \$40 million in performance coverage and \$40 million in payment coverage for that one project. For an SDI user, the total available coverage for that job and all other jobs that general contractor has might only be \$50 million in total.¹² Absent dedicated limits for a specific project, (which appears to be available, at a price, from the SDI insurer) the sureties for some general contractors are concerned that the SDI coverage is insufficient to allow those sureties to extend the amounts of surety credit those general contractors require.
- SDI coverage is not subject to a sub-limit per subcontractor. Thus, the \$50,000 window caulking subcontractor who performs poorly and causes a \$20 million loss because of water penetration may be fully covered (subject to deductibles and co-pay), whereas only \$50,000 in subcontract bond coverage would have been available had the same subcontractor been bonded.
- SDI pricing may vary depending on the general contractor, volume of subcontracted work, and market factors, but usually consists of two components, the risk transfer premium which covers the risk transfer to the carrier...i.e., the "cost of the insurance," and an additional loss sensitive premium, which together constitute the amount typically charged back by the general contractor to an owner or included as a cost of the work. The difference between the combined premiums and the risk transfer premium is handled in some form of loss sensitive structure, much the same as any large general contractor would benefit from savings, retro rating, or rebates on its other insurance products.

One Big Reason General Contractors Use SDI

An example of the pricing and risk/reward benefits of SDI will illustrate why this product has gained acceptance among so many large general contractors. Consider a general contractor with \$200 million in annual volume, of which 80% or \$160 million is subcontracted. That general contractor will pass on an SDI combined premium to

¹² Limits are, however, reinstated annually and a subcontractor default is deemed to be one loss regardless of the number of subcontracts. So, two or three policies may be triggered based on the subcontract date as mentioned above.

its project owners in an amount competitive with subcontract bonding, say 1.5%, or \$2,400,000. Assume a risk transfer premium of 0.4% for risk transfer, or \$640,000. Assume another 0.2%, or \$320,000, in program costs to the general contractor for administering its SDI program and prequalification efforts. If the general contractor is good at prequalification and risk management, and has no losses, the general contractor's SDI loss sensitive program may benefit by as much as \$ 1,440,000 (\$2,400,000 - \$640,000 - \$320,000). That amounts to 0.7% of its gross volume for that year. To a general contractor working in an industry where 3% gross margins are already considered good, this is a real incentive to prequalify and manage subcontract risks.

Of course, the foregoing assumes no defaults. All it would take is a default of one mechanical contractor on one of the general contractor's many projects to wipe out all of the favorable loss experience. For this reason, most SDI contractors use those funds as a reserve fund against loss, building up a substantial reserve over time. And, while critiques of SDI once predicted that general contractors would load up on low bid unqualified subcontractors because they had insurance, the opposite has proven to be true. General contractors using SDI have become more risk adverse than their counterparts using bonds. They challenge themselves to earn back as much of that experience premium as they can.

The Subcontractors View of SDI

Subcontractors may have mixed reactions to working on SDI project. On one hand, they are not required to use their available surety credit. That means that the owners of the subcontracting entity may not have personal liability as they would to their surety. It also means that scarce surety credit is available for other projects. On the other hand, they may find that the general contractor, sensitive to the amounts it is self-insuring, has imposed tighter controls on progress payments, requires personal guaranties, or asks for sensitive financial information that would not have to be provided in a bonded situation.

The Suppliers View of SDI

Suppliers to subcontractors may or may not find it as easy to extend credit to subcontractors on SDI projects. SDI affords them no direct payment bond coverage. They are required to file liens against the project and project owner, or claims against the general contractor's surety. Most subcontract payment bonds provide direct actions for suppliers and have less restrictive notice requirements than lien laws and statutory bonds. A supplier often has a claim against a subcontract bond when it has already missed the deadlines to file against the project or general contractor's bond. On the other hand, suppliers may take comfort that the general contractors will be more rigorous in their monitoring of payments and securing of interim lien releases, or more inclined to pay lien or bond claims with SDI as a source of recovery.

The Project Owners View of SDI

Project owners may find no significant difference between a general contractor bonding its subs and using SDI. The cost to the project is about the same. A general contractor that bonds its subs may suggest that it has better prequalified subcontractors, higher coverage limits, and greater payment protection for suppliers and second tier subcontractors (which theoretically creates an opportunity for better pricing). The SDI user may suggest that it has greater ability to address a default in a timely manner because it does not have to wait on the surety to respond and investigate. SDI users often suggest that the absence of subcontract bonding requirements will mean that the SDI user has greater flexibility to employ the small and minority contractors who are so often the target of public owners' social goals. In truth, both are excellent risk management tools in the hands of the sophisticated and usually well financed general contractors who use SDI. Whether or not a general contractor bonds or uses SDI may make no greater difference to the owner than which bonded general contractor uses SureTrack® and which one, Primavera® Project Planner for its scheduling software.

SDI Overview

SDI is an alternative to subcontract bonds that some general contractors may find attractive. General contractors who prefer to step in immediately when a subcontractor defaults and take control of remedial action, as opposed to waiting for a surety to take action, may find SDI attractive. The possibility of reduced bonding costs, or favorable subcontractor experience translating into savings in its loss sensitive premium structure, is also a factor that may cause a general contractor to prefer SDI. However, the potential savings of SDI could be lost if the general contractor does not make the commitment required under the SDI insurance program to screening and hiring only reputable and financially viable subcontractors and in rigorously employing sound risk avoidance and minimizations practices such as those mentioned at the beginning of this paper. If the operational discipline required for SDI is strictly adhered to, many general contractors have improved their operations, and profitability, by being forced to evaluate the cost of "self" assumed/non bonded risks.

Those general contractors in SDI programs are only now realizing how much work the prequalification process is, and how many defaults the surety product may have prevented for them over the years.¹³ Under the SDI program, the general

¹³ There is no question that the surety industry, as a whole, needs to continue to work on its image for responsiveness and responsible claims handling. Complaints about surety claims handling practices...sometimes justified and sometimes not...are among the principal reasons that general contractors initially enroll in SDI programs. Over time, many general contractors have come to appreciate some of the unseen services of the surety industry...for example, the subcontractor that is financed and "propped up" by its surety behind the scenes. Between the administrative cost of prequalification and administration, and the begrudging appreciation for the difficulty of a surety's role in a subcontractor failure, it is the author's experience that many SDI users have gained a newfound respect for the surety product.

contractor participates with the insurer financially in losses. Indeed, the general contractor is self insuring a great deal of the exposure. The extent to which general contractors can effectively avoid and manage subcontractor defaults will determine the potential costs savings.

Subcontractor Financial Prequalification

One of the most valuable services of the surety bond is the surety's independent prequalification of subcontractors. Prequalification is a process in which the surety underwriter and producer analyze the subcontractor's:

- Financial strength and credit history;
- Experience and reputation;
- Exposure and progress on other contracts; and
- Ability to perform the work; as well as
- Subcontract documents; and
- Size and location of the work.

A surety typically will have greater access to this information than a general contractor. The surety may be prequalifying the subcontractor for surety credit for many projects. The surety may have a long history of bonding the subcontractor. The subcontractor will share sensitive information with its surety on a confidential basis that it would never wish to share with its customer, the general contractor. As some SDI general contractors have undertaken the prequalification required of their SDI program, they have realized that obtaining the financial information necessary to make good decisions is not as easy as they thought it might be....that it is hard to replicate the financial analysis that the sureties have traditionally done. They have found that prequalifying subcontractors is difficult without the detailed confidential financial data, work-in-progress, and personnel resumes, and business plans that the surety company and bond producer have at their disposal. In an effort to obtain better financial information on their subcontractors, many are requesting detailed information through questionnaires similar to the one attached.

Some general contractors have staffed up to meet the challenge with their own prequalification departments. They have created elaborate databases with financial, safety, credit, and performance histories of their subcontractors. They have hired accountants or risk managers to analyze that information and make recommendations on which subcontractors may be safely enrolled in their SDI programs. Some have turned to accounting firms, surety brokers, consultants, and other companies who offer this service for a fee. Third party services offer a certain objectivity, independence from internal management pressures, and often resources

and experience that a general contractor would not be able to replicate internally. Third party services also offer subcontractors an opportunity to deliver proprietary or sensitive financial information, in confidence, to a third party without disclosure of the contents to the general contractor. A sample third party prequalification report, based on information furnished by the subcontractor to the general contractor, and analyzed in much the same way that a surety would analyze a subcontractor, is attached.

Understandably, most subcontractors are not excited about revealing to their general contractor customers their profitability on that general contractor's, or even a competitor's, project.

As contractors and subcontractors alike have moved assets from operating companies to holding companies, it has become more difficult to determine whether the subcontracting entity has any substantial worth or is viable as a standalone entity. While Subcontractor X may be a fine ol' company with whom the general contractor has done business for many years, general contractors are finding that Subcontractor X moved all its real worth upstairs to Subcontractor X, LLC. It often takes more financial information than a subcontractor would be willing to furnish a general contractor, and often more financial analysis expertise than the contract has in-house to unravel that information.

The practice pointer for the construction law practitioner is to be able to counsel its subcontractor clients why financial information that was never required in the past is now being requested. In the case of general contractors using SDI, they are taking on more risk and want the additional information to manage that risk. Whether or not subcontractors provide that information is, of course, up to them. Those who choose not to do so, however, are going to find their opportunities limited if more and more contractors begin to use SDI and take a greater interest in the financial strength of their subcontractors.

Funds Disbursement/ Funds Control Programs

Funds disbursement services, often called "funds control," "funds administration," or "construction escrow services" are services whereby a subcontractor's accounts payable functions are outsourced on a per-project basis to a third party escrow or disbursement service. In essence, the funds otherwise earned by a subcontractor are paid not to the subcontractor, but to a service provider who verifies costs, collects lien releases, and makes direct disbursements to the subcontractor's suppliers and sub-subcontractors on a pre-agreed basis. The level of control involved may be as light as what a general contractor might employ in routine joint checking of major suppliers to positive verification of costs and disbursement only of costs and allocable profit and overhead until the project has been completed.¹⁴

¹⁴ The attached sample Funds Disbursement Services Agreement is representative of disbursement methodology used by most sureties who require funds control as an underwriting requirement for the issuance of bonds.

Such services have proven to be a credit enhancement tool, an evaluation tool for contractors with limited experience, and an underwriting tool that allows a surety to extend or expand surety credit in certain circumstances. Funds disbursement services may be used in any situation where it is important that funds remain dedicated to the project on which they are earned. One such example would be a general contractor with an SDI program, using a marginally qualified trade subcontractor.

Funds disbursement services are not regulated in most states. Some states, like California, include such services under their Escrow Licensing Laws. In most, there is no regulation and no financial oversight. A recent case points out the dangers of dealing with any funds disbursement company that has not been thoroughly investigated. In *New York Marine and General Ins. Co. v. Beck Elec. Co., Inc.*, Slip Copy, 2007 WL 160689 W.D.N.C., 2007, January 16, 2007 Beck Electric Co., Inc. ("Beck Electric") contracted with Southside Constructors, Inc. ("Southside") to provide electrical subcontracting services for the Gaston County Administration Building construction project. However, due to its financial condition, Beck Electric was required by its surety to have a third-party funds administrator oversee the disbursement of funds from Southside to Beck Electric and/or Beck Electric's subcontractors. Beck Electric retained Houston, Texas based, Funds Administration Services, Inc. ("FAS") to serve as its third-party funds administrator. FAS allegedly misappropriated the funds entrusted to it and later filed bankruptcy. Beck Electric, deprived of the misappropriated funds, defaulted, causing a loss to its surety. The surety sued under its indemnity agreement to recover the loss. Beck Electric defended on the basis that FAS was an agent of the surety, and that the surety should therefore allow the misappropriated amount as a credit against Beck Electric's indemnity obligations. The Court found for the surety, leaving Beck Electric to suffer the losses caused by FAS's defalcation. The lesson: prequalify the funds administration service too!

Funds disbursement services are priced on dollar volume, length of project, and the complexity of the controls in place. An average of 1% of the contract amount on smaller projects is common, although the fees typically break as the subcontract price increases.

While joint check processes may send a message to the suppliers that a general contractor lacks confidence in the subcontractor, many funds disbursement processes are performed in a manner that third parties are unaware that it is being used. The checks from the disbursing company or escrow service may be imprinted with only the subcontractor's name and address.

Most subcontractors would prefer not to have their funds controlled and disbursed in this fashion. They fear that there will be disagreements over who should be paid, whether the process will slow down payment, and a certain amount of duplication of accounting functions. To the subcontractor who would otherwise not

qualify for bonds or to work for an SDI user, however, it is a process that creates opportunities where none may have existed before.

With increasing frequency, owners and lenders are requiring funds to be disbursed through escrow, either to obtain favorable pricing from subcontractors and other project team members, or to guard against default. Even those who require bonds sometimes prefer the comfort of knowing that project funds will positively remain dedicated to the project and not be used elsewhere.

A Word about Cost Reimbursement for all of these Products and Services

Public owners in Texas have, since 1995, have had the flexibility to do “best value” procurements where contractors, construction managers, and design-builders are hired on merit, not low price. These new delivery methods are often done on a cost plus a percentage fee basis. From time to time, a public owner will naively ask, “If we got a bond from the general contractor, why should we have to pay for the general to bond its subs?” Why such questions arise, I do not know. Subcontract bonds costs and SDI premium costs are, of course, compensable. Subcontract bonds or SDI premiums¹⁵ are as much a cost of the work as the subcontractor’s CGL coverage or workers compensation premiums. All major trade association promulgated standard construction forms consider such costs as compensable.¹⁶

There are some inquiries about subcontract bond or SDI costs that would be entirely appropriate at the proposal stage.¹⁷ Some owners want to know if a general contractor bonds some or all of its subcontractors or uses SDI. Those are, of course,

¹⁵ A project owner may question whether or not only the minimum risk transfer portion of the premium should be reimbursable. Indeed, some general contractors only charge that portion plus their administrative costs as a reimbursable cost to the owner. But, those contracts are also structured to make the general contractor’s deductibles and co-pay a fully reimbursable cost of the work...and the contract would have to stay open until the warranty and statute of repose has run to calculate it... typically a much larger and longer exposure than any project owner would wish to deal with.

¹⁶ AIA A121/CM (1991), for example, is one of the most common contract templates used by public owners in their Construction Manager at Risk Procurement. It includes as a cost to be reimbursed, in Section 6.1.6.1, “That portion directly attributable to this Contract of premiums for insurance and bonds.” It goes on to state that the CM should further specify the basis for reimbursement “if charges for self performance are to be included.”

¹⁷ Owners would be well advised to inquire how general contractors plan to deal with subcontractor risks and price their risk transfer costs in their requests for proposals. To say in the RFP, however, that a general contractor will not be able to include subcontract bonds of SDI in its costs, if the contract is awarded, could have an adverse impact on competition. It would be like saying, “General contractors who pay truck allowances to their superintendents instead of higher salaries need not apply.” General contractors each have their own means and methods of performing work, and their own methods of dealing with risk. To single out, or restrict, one element of their practices is shortsighted and reduces competition. Contractors should also be careful that the loss sensitive structure of their SDI program are not viewed incorrectly as creating rebates or hidden returns that might run afoul of any of the provisions of a cost-plus contract or violation of anti-rebating or similar laws relating to public procurement.

good questions, the answers to which demonstrate the general contractor's risk management philosophies and may have some indication of the quality of subcontractor that will be on the project. To suggest that a general contractor that does not bond its subcontractors or use SDI is somehow more competitive is a false premise. The minor savings to the project in terms of bond or SDI premiums, compared to the overall project cost, may pale in comparison to costs, delays, or quality issues associated with a subcontractor failure. The savings in premium may actually show up in other reserves or costs incurred by the general contractor in dealing with subcontractor risk issues. Full disclosure of the premiums and their rebate/loss sensitive returns is the best course of action, especially in dealing with public owners.

Choosing any general contractor in a best value procurement because its fee or fee and subcontract risk costs is lower than another general contractor's, when the overall project price is not known is like choosing and buying a car based solely on the cost of the tires.

Conclusion

Good subcontract risk management starts at home, with people and procedures focused on minimizing the risk of subcontractor default. No insurance or surety product...no third party service...will work unless the general contractor accepts this premise.

Having accepted this premise, there are a number of products and services available in the marketplace to reduce the risks of subcontractor failure. Each of these products and services are tools. No one tool is best. Each has its purpose. More than one tool may be needed on any project. It is hoped that the foregoing will be beneficial in the selection and use of those tools.

About the Author

Steve Nelson is the Executive Vice President & General Counsel of SureTec Insurance Company and President of its construction risk management and consulting firm, SureTec Information Systems, Inc. For 19 years Steve practiced construction and surety law in Dallas, Texas. He was the Chief Executive Officer of one of the largest commercial building contractors in Austin from 1995 to 2001. He serves on AGC's National Surety Industry Advisory Committee and co-chairs the Texas Building Branch AGC's Legislative Committee. Steve has served as the Chair of the Construction Law Sections of the Dallas Bar Association, Austin Bar Association, and the Construction Law Section of the State Bar of Texas. He is a Fellow of the American College of Construction Lawyers, a Fellow of the Center for Public Policy Dispute Resolution, and an Adjunct Professor at the University of Texas at Austin School of Engineering.

SureTec Insurance Company is a Texas domiciled surety company underwriting contract risks in Texas and California for subcontractors and general contractors requiring bid, performance, payment, and maintenance bonds on public and private works. For more information about SureTec, please go to www.suretec.com. SureTec Information Systems, Inc.(all states except California) and its sister company, SureTec Funding Corp. (California) provide funds disbursement services, escrow services, mediation services and subcontractor prequalification services nationwide.

Subguard Policy

Throughout this Policy the words "you" and "your" refer to the **Insured** shown in the Declarations and any other person or organization qualifying as an **Insured** under this Policy. The words "we", "us", and "our" refer to the company providing this insurance.

In consideration of the payment of premium, your undertaking to pay the Deductible and Co-payment amounts, if any, and in reliance upon the statements in the Application and **Qualification procedures** made a part hereof, and subject to all terms and conditions of this Policy, we agree with you as follows:

I. Insuring Agreement

Subject to the Limits of insurance stated in Item 3. of the Declarations, we will indemnify you for **Loss** after application of the Deductible and Co-payment amounts as stated in Items 4. & 5. of the Declarations and subject to the Retention aggregate stated in Item 6. of the Declarations, but only to the extent of a **Default of performance** by your **Subcontractor/Supplier** as respects any **Covered subcontract or purchase order agreement**.

II. Definitions

A. Balance of the subcontract or purchase order agreement price means the total amount of the **Covered subcontract or purchase order agreement**, plus any amounts to which the **Subcontractor/Supplier** is entitled, less the amount actually paid by you to the **Subcontractor/Supplier**.

B. Bodily injury means any bodily injury, physical injury, sickness, disease or death suffered or sustained by any person(s), and any pain, suffering, mental anguish, or emotional injury or distress of any kind suffered or sustained by any person(s).

C. Covered subcontract or purchase order agreement means those written binding agreements or other documents executed during the **Policy period** and utilized by you to evidence an agreement between you and your **Subcontractor/Supplier**, as such may be amended from time to time or is otherwise defined by endorsement to this Policy.

D. Default of performance means failure of the **Subcontractor/Supplier** to fulfill the terms of the **Covered subcontract or purchase order agreement** as determined by you or a legally binding authority. A determination by a legally binding authority shall supersede any previous determination.

E. Indirect costs mean costs and expenses paid by you to the extent caused by a **Default of performance** of a **Subcontractor/Supplier** and that are not specifically included in Definition **H. Loss**, Items **1.** through **4.** **Indirect costs** include, but are not limited to, those costs and expenses paid by you for liquidated damages, job acceleration, and extended overhead.

F. Insolvency/Insolvent means that any of the following steps, or equivalent steps, have been taken by or against a **Subcontractor/Supplier** by or in a court having jurisdiction over the **Subcontractor/Supplier's** affairs or pursuant to a statute applicable to the **Subcontractor/Supplier** and its creditors:

1. Bankruptcy or insolvency is adjudicated against the **Subcontractor/Supplier**.
2. Voluntary or involuntary proceedings are initiated under Chapter 7 or Chapter 11 of the Federal Bankruptcy Code of the United States or any similar statute in another country.
3. A court order is issued or the **Subcontractor/Supplier** accepts a voluntary resolution for the winding-up or liquidation of the **Subcontractor/Supplier's** affairs.

G. Insured means the person(s) or entity(ies) stated in Item **1.** of the Declarations or stated as an **Insured** by endorsement to this Policy.

H. Loss means the costs and expenses paid by you to the extent caused by a **Default of performance** of a **Subcontractor/Supplier** under the terms of a **Covered Subcontract or purchase order agreement**, less the unpaid **Balance of the subcontract or purchase order agreement price**, including any amounts retained or recovered by you with respect to the **Covered subcontract or purchase order agreement** of the defaulted **Subcontractor/Supplier**.

Such costs and expenses are:

1. Cost of completing **Subcontractor/Supplier's** obligations under the **Covered subcontract or purchase order agreement**, including amounts the defaulted **Subcontractor/Supplier** is required to pay under the **Covered subcontract or purchase order agreement** to third parties.
2. Cost of correcting defective or nonconforming work or materials.
3. Legal and other professional expenses paid by you and directly related to the **Subcontractor/Supplier Default of performance**.
4. Costs, charges, and expenses paid by you in the investigation, adjustment, and defense of disputes and directly related to a **Subcontractor/Supplier Default of performance**.
5. **Indirect costs.**

Multiple **Defaults of performance** by the same **Subcontractor/Supplier** on one or more **Covered subcontract or purchase order agreements** executed during a **Policy Period** shall be considered to be a single **Loss**.

Loss(es) will be attributed to the **Policy period** in which the **Covered subcontract or purchase order agreement** was executed, not the year(s) in which **Loss(es)** are actually paid by you.

- I. **Policy period** means the period of time set forth in Item 2. of the Declarations or any shorter period of time arising as a result of cancellation of this Policy in accordance with Section X., Item B. of this Policy.
- J. **Proof of loss** means a written description and any other supporting evidence, including the applicable **Covered subcontract or purchase order agreement(s)** and notice of **Default of performance**, that document a claim as a covered **Loss** and quantify the amount of the **Loss**.
- K. **Qualification procedures** means the written criteria that you have represented that you will adhere to in order to assure that the **Subcontractor/Supplier** will be able to carry out the terms of the **Covered subcontract or purchase order agreement**.
- L. **Subcontractor/Supplier** means:
 1. Any legal entity which has entered into a **Covered subcontract or purchase order agreement** with the **Insured. Subcontractor/Supplier** shall not include any subsidiary of the **Insured** now existing or hereafter formed or acquired, whether partially or wholly owned or controlled, or any subsidiary of a subsidiary (whether direct or indirect), or partnership, joint venture or corporation of the **Insured**.
 2. The receiver, trustee, liquidator, administrator, or similar representative of any **Subcontractor/Supplier** as described in 1., or its creditors, or the **Subcontractor/Supplier** as described in 1. as debtor in possession under Chapter 11 of the Federal Bankruptcy Code or any similar statute in another country.

3. Any successor to such legally existing entity, corporation, proprietorship, receiver, trustee, liquidator, administrator, or similar representative referred to in 1. and 2.
4. Any corporation and other entity controlling, controlled by, or under common control of such legally existing entity, corporation, proprietorship, receiver, trustee, liquidator, administrator, or similar representative referred to in 1., 2. and 3.

III. Exclusions

This insurance does not apply to **Loss**:

- A. Arising from any **Covered subcontract or purchase order agreement** for which a payment and/or performance bond has been procured and in which you are an obligee.
- B. Arising from any **Subcontractor/Supplier** who is in or to whom you have issued written notice of **Default of performance** and said default has not been cured as of the first day of the **Policy period**, unless this is a renewal of a Policy previously issued by us, in which case you must disclose such **Default of performance** at of the renewal date of this Policy. Such disclosure will extend this insurance to the **Subcontractor/Supplier**, unless the **Subcontractor/Supplier** is specifically excluded by endorsement to this Policy. Failure to make such disclosure will exclude insurance for the **Subcontractor/Supplier** under the renewal Policy.
- C. To the extent caused by any dishonest or fraudulent act or omission, or any intentional misrepresentation committed by you.
- D. Arising from any **Covered subcontract or purchase order agreement** that is purchased or otherwise acquired by you from any other person or entity, or sold or otherwise transferred by you to any other person or entity, unless specifically agreed to in writing by us.
- E. To the extent caused by a material breach of or inaccuracy regarding any **Warranty and covenants**, in accordance with Section IX. of this Policy, made herein or a material failure to perform or to fulfill any warranty, covenant, or agreement made by you in conjunction with a **Covered subcontract or purchase order agreement** and projects in which such covered agreements are related.
- F. Arising from nuclear reaction or nuclear radiation or radioactive contamination.
- G. Arising from any consequence, whether direct or indirect, of war, invasion, act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection or military or usurped power, riot, or civil commotion.

H. Arising out of your rendering of or your failure to render professional services or the failure of a **Subcontractor/Supplier** to render professional services, including (a) the preparation or approval of maps, drawings, opinions, reports, surveys, designs, or specifications and (b) supervisory inspection or engineering services.

This Exclusion does not apply to (1) the normal supervisory duties of a general contractor on a construction project or (2) a **Default of performance** by a **Subcontractor/Supplier** engaged by you whose work includes any responsibility for furnishing professional services in conjunction with construction services where less than 50% of the **Subcontractor/supplier** contract price charged by the **Subcontractor/Supplier** is from professional services.

I. Arising from or related to, either directly or indirectly, **Bodily injury**.

IV. Territory

This insurance only applies to claims made or brought in the United States, its territories or possessions, Canada, or Puerto Rico.

V. Deductible and Co-payment Amounts

The Deductible, if any, is the amount of each **Loss** that is to be borne by you with respect to each and every **Loss** to which this Policy applies. The Deductible amount is stated in Item 4. of the Declarations.

Your Co-payment amount, if any, applies to each **Loss** after application of the Deductible. The Co-payment amount is stated in Item 5. of the Declarations.

Your total liability for all Deductible and Co-payment amounts for all **Loss** to which this insurance applies shall not exceed the Retention aggregate amount shown in Item 6. of the Declarations.

Your rights and duties in the event of a **Default of performance** apply irrespective of the application of the Deductible and Co-payment amounts.

VI. Limits of insurance

A. The Limits of insurance stated in Item 3. of the Declarations and the rules below determine the most we will pay regardless of the number of:

1. **Insured(s)** or;
2. **Subcontractor(s)/Supplier(s)**; or
3. **Covered subcontract or purchase order agreement(s)**; or
4. Claims or suits brought; or
5. Persons or organizations making claims or bringing suits.

B. The Aggregate limit of insurance stated in Item 3a. of the Declarations is the most we will pay for the sum of all **Loss(es)** in excess of Deductible and Co-payment

amounts from all **Defaults of performance** as respects all **Covered subcontract or purchase order agreements**.

Once the Aggregate limit of insurance in any **Policy period** has been completely eroded, we shall have no further obligation to indemnify you for **Loss(es)**.

C. Subject to B. above, the Each **Loss** limit of insurance shown in Item 3b. of the Declarations is the most we will pay for any one **Loss**.

D. Subject to C. above, we will not pay more than the Each **Loss** indirect costs sublimit of insurance shown in item 3c. of the Declarations for all **Indirect costs** from any one **Loss**. Any amounts that we pay to indemnify **Indirect costs** under this paragraph D. will erode the Each **Loss** limit of insurance applicable to the coverage provided for any one **Loss**.

VII. Claims

The burden of proving that you have complied with the terms and conditions of, and that the **Loss** is recoverable under, this Policy shall fall upon the **Insured**.

You shall give written notice to us within 30 days from the time you become aware that a **Subcontractor/Supplier** is in **Default of performance** under the **Covered subcontract or purchase order agreement** or is **Insolvent**.

In the event of **Loss**, you must submit to us a satisfactory **Proof of loss**. Submission of a **Proof of loss** must be made at the earlier of:

1. The expiration of any statute of limitation or statute of repose applicable to recovery against the **Covered subcontract or purchase order agreement** or to the **Loss**; or-
2. The expiration of any right to seek recovery under any **Covered subcontract or purchase order agreement** in connection with a **Default of performance** covered herein; or
3. 10 years after the substantial completion of the **Covered subcontract or purchase order agreement**.

Our indemnification of your **Loss** shall be calculated as follows, subject to the provisions of this Policy and subject to the Limits of insurance:

1. Calculate the amount of the **Loss**.
2. Subtract the Deductible from the lesser of either the **Loss** or the applicable Each **Loss** limit of insurance.
3. Multiply the lesser of either the amount determined in 2. above or the amount stated in Item 5b. of the Declarations, by the Co-payment percentage stated in Item 5a. of the Declarations.
4. Subtract the amount determined in 3. above from the amount determined in 2. above.

We will indemnify you for a **Loss** within thirty (30) days after we receive a **Proof of loss**. In the event you provide

us with documentation that you present as a **Proof of loss** that we find to be deficient, we will notify you of the deficiencies within thirty (30) days after our receipt of such documentation. We shall make payment for a **Loss** within thirty (30) days from the date upon which we receive the information necessary to cure any such deficiencies.

You may submit interim **Proofs of loss** for **Loss(es)** that you pay over a period of time greater than thirty (30) days. If an amount would constitute a **Loss** except that the amount of the **Loss** has not been finally determined, we will indemnify you for the Interim Percentage, as stated in Item 7. of the Declarations, of the **Loss** payment which would have been payable as calculated above, after we accept a satisfactory **Proof of loss**.

You must immediately return any payments made by us upon a legally binding determination that the **Loss** does not arise out of a **Default of performance**.

The **Proof of Loss** and any amounts claimed as covered **Loss(es)** under this Policy are subject to audit by us in accordance with Section X., Item A. of this Policy.

In the event you and we cannot agree that a claim is a **Loss** or cannot agree on the amount of **Loss** you have incurred and paid, either party may commence arbitration proceedings in accordance with Section X., Item M.

VIII. Subrogation and recoveries

In the event of any payment by us under this Policy, we shall be subrogated to the extent of such payment to all of your rights of recovery or other remedies against any persons or organizations with respect to such payment.

Unless otherwise agreed to by the parties, we shall, at our option, pursue all recovery and subrogation actions.

You must take all reasonable steps to preserve our rights of recovery against any such persons or organizations. You shall do nothing to materially prejudice such rights.

You must cooperate with us in the investigation, settlement, or defense of any claim or suit; and you must assist us, upon reasonable request, in the enforcement of any right against any person or organization which may be liable to you because of **Loss** to which this insurance applies, including but not limited to filing any claims and enforcing any liens or security interest against a **Subcontractor/Supplier** or its property.

After payment of the **Loss**, any such funds or salvage recovered will be paid to us and shared between you and us as follows:

1. First, we will be fully reimbursed for our costs of recovery.
2. Second, we will be fully reimbursed for the insured **Loss** amount in excess of the sum of the Deductible and Co-payment amounts as stated in Item 4. and 5b. of the Declarations, respectively.

3. Then you and we shall share, based on the Co-payment percentage stated in Item 5a. of the Declarations, any remaining sums until the amount of our payment of the **Loss** and our cost of recovery have been fully reimbursed.
4. All further sums recovered shall be retained by you.

The application of amounts recovered as described above apply regardless of any designation of amounts by the **Subcontractor/Supplier** or any other party.

IX. Warranty and covenants

You warrant and agree:

- A. To cease awarding contracts to any **Subcontractor/Supplier** that is in **Default of performance** and for so long as the **Subcontractor/Supplier** is in **Default of performance**.
- B. That in the event you become aware of the **Insolvency or Default of Performance** of the **Subcontractor/Supplier**, you shall immediately take all reasonable and timely actions necessary to preserve any rights of recovery against and establish the debt owed by the **Subcontractor/Supplier** to you as a valid obligation of the **Covered subcontract or purchase order agreement** in accordance with any applicable statutes and procedures.
- C. To use all reasonable measures to prevent and to mitigate the **Loss** at all times.
- D. To retain without recourse to any party the sum equal to the Deductible and Co-payment amounts. The foregoing shall not preclude you from receiving guarantees, letters of credit, or other forms of assurances from subsidiaries, parent companies, affiliates, officers, representatives, principals, owners or partners of any **Subcontractor/Supplier** or project Owner. The amounts of such assurances shall not, however, serve to satisfy your Deductible or Co-payment amounts.

X. Conditions

A. Inspection and audit

We shall be permitted but not obligated to inspect, sample, and monitor your property or operations, examine or require to be produced copies of any corporate records or books, internal documents and correspondence, letters, or other documentation or records, in whatever form and wherever situated in your possession or control relating to or connected with this Policy or to any transaction between you and a **Subcontractor/Supplier**. At our request, you must take any and all reasonable steps to obtain such information in the possession of others relating to or connected with this Policy or any **Loss**. This section shall not apply to information which you have been required by a court order or federal agency to provide restricted access.

We will treat your proprietary information as

confidential.

B. Cancellation

You are not permitted to cancel this Policy.

We are not permitted to cancel this Policy, except for:

1. Nonpayment of premium; or
2. Upon a **Change in the composition of the Insured**, as provided in Section X., Item C.; or
3. As provided in Section X., Conditions H. **False or fraudulent statements, report or claims concealment**; or
4. Upon repeated violations in the application of your **Qualification procedures**. In the event of repeated violations in the application of the **Qualification procedures**, we will send you a notification of our intent to cancel this Policy by certified mail. This notification will delineate the violations of the **Qualification procedures** for which we are canceling the policy and will provide you thirty (30) days to provide a cure. If you have not provided a reasonably satisfactory cure during this period, the Policy will be cancelled 30 days after the date which initiated the cure period.

In the event of such cancellation for items 1. and 3. above, we must deliver via certified mail to the **Sole agent** written notice stating not less than 10 days thereafter such cancellation shall be effective.

If the Policy is canceled, a return of premium shall be made to you. The amount of return premium shall be calculated as the Policy premium paid less the premium attributable to the **Covered subcontract or purchase order agreements** subject to this Policy and executed during the **Policy period** prior to the effective date of cancellation, subject to any applicable minimum premium stated in Item 9. of the Declarations.

The effective date of cancellation stated in the notice shall become the end of the **Policy period**. Our cancellation of this Policy shall not affect coverage under this Policy for **Loss** arising out of a **Default of performance** under any **Covered subcontract or purchase order agreement** executed during the **Policy period** prior to the date of cancellation.

C. Change in the composition of the Insured

You must notify us within thirty (30) days in writing if, during the **Policy period**, you consolidate, merge with, or sell all or substantially all of your assets to any other person or entity, or if another person or entity should acquire beneficial ownership of shares having a majority of the ordinary voting power in the election of directors. Upon receipt of such notice, we may at our option cancel this Policy effective thirty (30) days after the date of such **Change in the composition of the Insured**.

D. Choice of law

In the event that you and we dispute the meaning, interpretation, or operation of any term, condition, definition, or provision of this Policy resulting in litigation, arbitra-

tion, or other form of dispute resolution, the law of the State of New York shall apply and all litigation, arbitration, or other form of dispute resolution shall take place in the State of New York.

E. Assignment

Assignment of interest under this Policy shall not bind us unless our consent is endorsed to this Policy.

F. Other insurance

This insurance shall be excess only and non-contributing over any other valid and collectible insurance available to you, whether such other insurance is stated to be primary, pro rata, contributory, excess, contingent, or otherwise, unless such other insurance is written only as a specific excess insurance over the limits of insurance provided in this Policy.

G. Action against us

1. No one may bring legal action against us under this Policy unless all material terms of the Policy have been complied with and such action is commenced:
 - a. within seven years following the last day of substantial completion of any **Covered subcontract or purchase order agreement** entered into during the **Policy period**; or
 - b. within six months after our first disposition of a specific claim which is the cause of the action or proceeding, whichever event occurs later.

H. False or fraudulent statements, report or claims concealment

If you make any statement, report, or claim known to be false or fraudulent, or if you knowingly conceal any material fact, we may, at our option, void this Policy. All claims amounts paid shall be returned to us with interest by you upon demand. All premium paid by you hereunder shall be returned by us. The conditions contained in section H. represent the sole reasons by which we may void this policy.

I. Premium audit

Premium shown in Item 8. of the Declarations is a deposit premium only. At the close of each audit period we will compute the earned premium for that period and send notice to the **Sole agent** as defined in Section X., Conditions L. **Sole agent**. The due date for any audit and retrospective premiums, if applicable, is the date shown as the due date on the bill. If the sum of the deposit and audit premiums paid for the **Policy period** is greater than the earned premium, we will return the excess to the **Sole agent**. If the sum of the deposit and audit premiums paid for the **Policy period** is less than the earned premium, you must pay us the balance owed.

J. Changes

Notice to any agent or by any other persons shall not effect a waiver or a change in any part of the Policy or

stop us from asserting any right under the terms of this Policy; nor shall the terms of this Policy be waived or changed, except by endorsement issued to form a part of the Policy.

K. Sole agent

The **Insured** named in Item 1. of the Declarations shall act on behalf of all **Insured(s)** for all purposes, including but not limited to the payment or return of premium, receipt, and acceptance of any endorsement issued to form a part of this Policy, complying with all applicable notice provisions, giving and receiving notice of cancellation or non-renewal.

L. Declarations

By acceptance of this Policy, you agree that the statements made in the Application and **Qualification procedures** are your agreements and representations, that this Policy is issued in reliance upon the truth of such representations, and that this Policy embodies all agreements existing between you and us.

Furthermore, you warrant and represent that you have no knowledge at Policy inception of any circumstances that may reasonably result in a **Loss**, except for that which is specifically disclosed in the Application.

M. Arbitration

Any dispute or other matter in question arising between you and us arising under, out of, in connection with or in relation to this Policy shall be submitted to arbitration within thirty (30) days of a request by either party to the other for such arbitration. The parties hereby agree to pursue such arbitration through the American Arbitration Association (AAA) in accordance with its then existing Commercial Arbitration Rules.

The parties further agree that from the list of arbitrators provided by AAA a panel of three neutral arbitrators shall be agreed upon. In the event of disagreement as to the panel or any member thereof, the selection of that arbitrator or those arbitrators shall rest with AAA. A decision in writing signed by a majority of the arbitrators, when served upon both parties, shall be binding upon both and judgement thereon may be entered in any court having jurisdiction thereof.

The arbitrators shall not be required or obliged to follow judicial formalities or the rules of evidence except to the extent required by governing law which is agreed between the parties to be the state law of the situs of the arbitration as herein agreed. Any decision of the arbitrators shall be subject to the "Limits of Indemnity" of this Policy. The parties shall submit their respective cases to the arbitrators within such period as may be mutually agreed between the Parties or failing such agreement, within thirty days of the appointment of the panel of arbitrators.

The arbitrators shall make an award in writing within forty-five days of the date on which the respective cases should have been submitted. The parties shall share equally in the payment of the fees of the arbitrators and

the remaining costs of the arbitration shall be paid, as the award shall direct. Any arbitration shall take place in New York unless otherwise agreed. Failure by the party receiving the request for arbitration to agree to such arbitration or state their reasons for not being prepared to submit to such process within the thirty days following the receipt of the request for arbitration, shall be adjudged an acceptance of the other party's position and the terms associated therewith and an agreement to take such action as would be consistent with such acceptance.

The parties hereto agree that they have entered into this agreement by virtue of this clause to provide for a means of quickly settling disputes without resort to litigation, but this agreement in no way infringes on any rights to take such legal action accorded in the Service of Suit Clause of this Policy, the sole effect and intent of which is to provide, without waiver of any defense, an ultimate assurance of the amenability of the Company to due process in certain courts with respect to a claim hereunder following an arbitration decision determining that such amount is due. The parties agree however, that unless and until an award has been rendered by such panel of arbitrators, no other action or legal proceeding shall be commenced in respect of any claim hereunder.

Nothing contained herein shall be construed to allow the arbitrators or any court or any other forum to award punitive, exemplary or any similar damages. By entering into this agreement to arbitrate the parties expressly waive any claim for punitive, exemplary or similar damages. The only damages recoverable under this agreement are compensatory damages.

COMPANY LOGO HERE

SUBCONTRACTOR QUESTIONNAIRE

PLEASE COMPLETE CAREFULLY, ATTACH REQUESTED INFORMATION AND SUBMIT DIRECTLY TO:

*Attn: Company Name Here
Street Address
City, State, Zip*

GENERAL INFORMATION

DATE: _____

COMPANY _____

ADDRESS _____ **PHONE # ()** _____

CITY/STATE/ZIP _____ **FAX # ()** _____

CONTACT NAME: _____ **E-MAIL** _____

WEBSITE ADDRESS _____

DATE BUSINESS STARTED _____ **FEDERAL TAX ID #** _____

COMPANY IS A: PROPRIETORSHIP _____ PARTNERSHIP _____ CORPORATION _____ SUB S CORP _____

OWNERSHIP

NAME _____ **TITLE** _____

YEARS IN POSITION _____ **%OWNERSHIP** _____

NAME _____ **TITLE** _____

YEARS IN POSITION _____ **%OWNERSHIP** _____

NAME _____ **TITLE** _____

YEARS IN POSITION _____ **%OWNERSHIP** _____

TOTAL NUMBER OF EMPLOYEES _____

IS YOUR COMPANY A M/WBE? YES _____ NO _____ **IS YOUR COMPANY A HUB?** YES _____ NO _____

IS YOUR COMPANY: UNION _____ NON UNION _____

BANK INFORMATION

NAME THE COMPANY'S PRIMARY BANKING RELATIONSHIP

INSTITUTION _____ **CONTACT NAME** _____

LOCATION _____ **PHONE** _____

HOW LONG WITH THIS BANK _____

DOES THE COMPANY MAINTAIN A LINE OF CREDIT WITH THIS BANK YES _____ NO _____

IF YES, AMOUNT OF LINE _____ **EXPIRATION/RENEWAL DATE** _____

CURRENT SURETY

COMPANY NAME _____ **HOW LONG** _____

BONDING CAPACITY SINGLE JOB LIMIT \$ _____ AGGREGATE LIMIT \$ _____

WHAT PERCENT OF YOUR WORK IS USUALLY BONDED _____% LARGEST BONDED JOB \$_____

HAS YOUR COMPANY OR ANY AFFILIATED COMPANY OR ANY OF ITS PRINCIPALS EVER PETITIONED FOR BANKRUPTCY, FAILED IN BUSINESS, CLOSED A BUSINESS, DEFAULTED OR FAILED TO COMPLETE ON A CONTRACT, OR BEEN ASKED TO POST COLLATERAL AGAINST A LOSS? YES _____ NO _____ IF YES, EXPLAIN_____

IS YOUR COMPANY OR ANY OF ITS OWNERS OR OFFICERS CURRENTLY INVOLVED IN LITIGATION, ARBITRATION, OR PROSECUTION OR DEFENSE OF FORMAL CLAIMS IN CONNECTION WITH ANY CONTRACT, PROJECT OR SUBCONTRACT? YES _____ NO _____ IF YES, EXPLAIN_____

WORK INFORMATION

TYPICAL PROJECT SIZE

Less than \$50,000 _____	\$50,000 - \$250,000 _____	\$250,000 - \$500,000 _____
\$500,000 - \$1,000,000 _____	\$1,000,000 - \$2,500,000 _____	\$2,500,000 plus _____

CURRENT WORK

NUMBER OF CONTRACTS IN PROGRESS _____

TOTAL CONTRACT VALUE OF CURRENT JOBS \$_____ CURRENT BACKLOG \$_____

LIST THE THREE LARGEST JOBS COMPLETED IN THE LAST FIVE YEARS

PROJECT / LOCATION _____ CONTRACT AMOUNT \$ _____

PROJECT / LOCATION _____ CONTRACT AMOUNT \$ _____

PROJECT / LOCATION _____ CONTRACT AMOUNT \$ _____

LIST JOBS COMPLETED WITH COMPANY NAME HERE

PROJECT / LOCATION _____ CONTRACT AMOUNT \$ _____

PROJECT / LOCATION _____ CONTRACT AMOUNT \$ _____

PROJECT / LOCATION _____ CONTRACT AMOUNT \$ _____

WE CERTIFY THAT ALL INFORMATION IN THIS QUESTIONNAIRE AND THE ATTACHMENTS IS TRUE AND CORRECT. WE HEREBY AUTHORIZE COMPANY NAME HERE AND ITS REPRESENTATIVES, TO INVESTIGATE DIRECTLY WITH THE REFERENCES GIVEN HEREIN, ANY INFORMATION PERTAINING TO THE UNDERSIGNED AND/OR THE INDIVIDUALS INVOLVED THEREIN. WE AUTHORIZE OUR FINANCIAL INSTITUTIONS, PRIOR AND EXISTING SURETIES, CUSTOMERS, CREDITORS AND SUPPLIERS TO RELEASE CREDIT HISTORY AND OTHER UNDERWRITING/QUALIFICATION INFORMATION.

SUBMITTED BY:

NAME _____

TITLE _____

DATE _____



SureTec Information Systems, Inc.

Houston • Austin • Dallas • San Diego

SUBCONTRACTOR PRE-QUALIFICATION REPORT

Prepared January 17, 2007 for the Exclusive & Confidential Use of Client Construction

This report has not been reviewed by the Subcontractor.

Date of Report **01/17/07** **Current as of** **12/31/06**

Subcontractor **EFFICIENT ELECTRIC, INC.**

Address: 1500 S. Williams
City St: Brownsville, Texas
Phone: 254-555-0022
Fax: 254-555-0023
Contact: Bob Smith
E-mail: bsmith@efficientelectric.com
Website: www.efficientelectric.com

Trade Specialty **Electrical Contractor**

Rating **Two Ratings (See explanation in Rating Rationale below):**

A (Excellent), Limits \$10 million (single)/\$30 million (aggregate)
Or, NA-1 (Unratable), No Limits Suggested

Rating Rationale The Company has provided quality electrical services in the South Texas area for nearly forty years. Originally founded by Bob Smith, sons Ben and Bob, Jr. currently own and manage the Company. A number of major projects have been completed, including Shore Condominiums (\$18 million), South Coliseum (\$16.2 million) and Gulf Convention Center (\$14 million). The Company has worked for quality contractors such as Turner, Beck and Hensel Phelps. Banking and bonding relationships are firmly established. In 2005, the Company created a new LLC as its operating company. While consolidated statements show financial strength to support historical project sizes, we were refused financials on the operating company. According to CFO, Charles Adams, the operating company is not well capitalized for risk management reasons. Several lawsuits were filed involving construction defects on school jobs performed in the Lower Rio Grande Valley. And, while the insurance company has paid the claims (which the Company felt were unfounded), the Company still recognizes a certain level of vulnerability in having a large amount of net worth within reach of plaintiff's attorneys.

While this may have been a good strategy for risk management/wealth preservation reasons, it leaves an operating company of questionable financial standing. We have provided two ratings: 1. 'A' (Excellent) with suggested limits of \$10 million (single)/ \$30 million (aggregate) if the parent company agrees to indemnify or if operating company financials are provided supporting recommended job limits. Or, 2. NA-1 (Unratable) and no limits recommended, if parental indemnification is not available and operating company financials do not support rating.

Financial Summary (Consolidated Financials)

Statement Date	Revenue	Equity	Working Capital
12/31/06	\$ 52,234,000	\$ 7,256,000	\$ 6,756,000
12/31/05	\$ 48,423,000	\$ 6,876,000	\$ 6,143,000

The Company provided financial statements for 12/31/05 and 12/31/06. The statements are consolidated and include the Company's LLC formed in 2006 that currently serves as the operating company. The statements were audited by Accountant's, Ltd. and clean opinions were issued. The percentage-of-completion method of accounting was used to record contract revenues. While consolidated financials show strong working capital and equity positions, we were not allowed access to statements for the LLC and are unable to establish financial strength of the operating entity. Consolidated statements show excellent liquidity and minimal long-term debt. Cash positions are strong and revenues and profits increased in 2006. However, information regarding the financial condition of the operating entity is critical in establishing a rating and recommend job limits.

Surety Bonding The Company indicates that it has used CNA as its surety for approximately 15 years. Limits were stated as \$12 million (single)/ \$30 million (aggregate). These amounts are consistent with consolidated financials. The Company's agent is Smith Insurance in Brownsville.

History / Organization The Company was founded in 1968 by Bob Smith who had spent 8 years as senior project manager for Gulf Electric in Beaumont prior to starting the Company. In 1992, sons Ben and Bob, Jr. took over management. Approximately 350 are employed and a 20,000 sq.ft. building in Brownsville is owned for operations. The Company primarily works on educational, hospital, retail and condominiums. Most jobs are performed in South Texas but projects have been completed across the state. Typical project size is \$3 million to \$5 million.

Banking Relations Banking operations have been conducted with Southern Texas Bank for approximately 18 years. Kevin Clark is the officer on the account. Mr. Clark confirmed that 6-figure operating accounts are maintained and that a line-of-credit of \$3 million has been established. Approximately \$2.4 million of the line was available at 12/31/06.

Credit History According to a third-party report, the Company's payment history is above-average when compared to its peers. Approximately 80% of payments are made within terms and no significant liens or past-due accounts were listed.

Legal Several lawsuits were found involving work performed at Valley H.S. and El Grande Elementary. Actions were filed regarding construction issues that resulted in faulty wiring and breaker defects. While the Company has not acknowledged fault and insurance has covered damages to date, there still may be risk of additional exposure which cannot be measured at the date of this report. The Company has attempted to focus this potential liability within its new operating company LLC.



References The Company has a good reputation and has worked for quality contractors such as Turner, Beck, Centex, McCarthy Builders and Hensel Phelps. Largest jobs are in the \$15 million to \$20 million range. Most notable projects are Shore Condominiums, South Coliseum and Gulf Convention Center. References indicated that the Company performed its work on time and was adaptable to change orders.

Backlog/Work Program A work-in-progress report was provided dated 01/01/07. Forty-two jobs were listed totaling \$58 million. Backlog was \$26 million, a manageable amount based on consolidated financials. Largest job was \$14.5 million and average job size was \$1.4 million.

Summary The Company has a long history of quality work. Based on consolidated financials, working capital and equity positions are adequate to take on large projects. However, with the exposure of recent lawsuits, financial condition of the operating company (LLC) is imperative to ensure that adequate resources are available for the recommended job sizes.

TERMS OF USE

This report is for the exclusive and confidential use of the general contractor named above ("Customer") in strict accordance with the terms of Customer's contracts with SureTec Information Systems, Inc. ("SureTec"). This report may not be duplicated nor shared with others without the express written permission of SureTec. A rating by SureTec is not a warranty of a subcontractor's current or future ability to meet its contractual obligations. All ratings must be considered in light of the subcontractor's then current workload, the size of any project to be undertaken, the scope and price of any undertaking, and all other relevant information available to the Customer. Each rating or other opinion must be considered, if at all, as only one factor in any contracting decision made by Customer. The ratings and other opinions contained herein must be construed solely as statements of opinion and should not be construed as statements of fact. SureTec relies on information provided by the subject subcontractor, its accountants, counsel, vendors, and third parties and does not perform an audit or attempt to further verify the accuracy of the provided information in connection with any rating. In certain circumstances, SureTec and its strategic partners may receive compensation from parties other than the Customer for determining ratings. Such compensation is based on the time and effort to determine the ratings and, in some instances, may be paid by the entity being rated. The information furnished is provided **"AS IS" WITHOUT WARRANTY OF ANY KIND, EITHER EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO, THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. NEITHER SURETEC NOR ITS STRATEGIC PARTNERS SHALL BE LIABLE TO CUSTOMER, SUBJECT SUBCONTRACTOR, OR ANY THIRD PARTY FOR ANY LOSS OR INJURY ARISING OUT OF OR CAUSED, IN WHOLE OR IN PART, BY SURETEC'S OR ITS STRATEGIC PARTNERS' NEGLIGENCE OR OTHER ACTS OR OMISSIONS IN PREPARING OR DELIVERING THIS REPORT. SURETEC AND ITS STRATEGIC PARTNERS WILL NOT BE LIABLE FOR CONSEQUENTIAL DAMAGES, EVEN IF ADVISED OF THE POSSIBILITY OF SUCH DAMAGES. IF, NOTWITHSTANDING THE ABOVE, SURETEC OR ITS STRATEGIC PARTNERS ARE HELD TO BE LIABLE THE AMOUNT OF SUCH LIABILITY SHALL NOT EXCEED THE GREATER OF \$1000.00 OR THE AMOUNT PAID TO SURETEC FOR THIS REPORT.**

Account Name	EFFICIENT ELECTRIC, INC.					
F/S Type	Audit		Audit			
Date	12/31/06		12/31/05		Year 1	
Balance Sheet	As Stated	As Allowed	As Stated	As Allowed	As Stated	As Allowed
Current Assets						
Cash	1,243,222	1,243,222	986,111	986,111		0
Marketable Securities		0		0		0
Total Cash & Equivalents	1,243,222	1,243,222	986,111	986,111	0	0
A/R - Trade	8,799,533	8,799,533	7,833,778	7,833,778		0
Retainage	786,999	786,999	689,330	689,330		0
Other Receivable		0				0
A/R Employee		0		0		0
Total Receivables	9,586,532	9,586,532	8,523,108	8,523,108	0	0
Costs Excess Billings	1,200,234	1,200,234	928,847	928,847		0
Prepays & Deposits	647,093	0	582,001	0		0
Inventory		0		0		0
Investment in Joint Venture						
Deferred federal income tax	277,330		299,442			
Cash Value Life Ins.		0		0		0
Total Current Assets	12,954,411	12,029,988	11,319,509	10,438,066	0	0
Non-Current Assets						
Notes Receivable	100,334	100,334	177,399	177,399		0
Machinery & Equipment	244,667	244,667	222,840	222,840		0
Land & Buildings	2,600,333	2,600,333	2,783,903	2,783,903		0
Other Fixed Asset		0		0		0
Depreciation	1,033,292	1,033,292	1,048,220	1,048,220		0
Net Fixed Assets	1,811,708	1,811,708	1,958,523	1,958,523	0	0
Prepaid & Deposits		647,093		582,001		0
Investments	188,333	188,333	167,390	167,390		0
Inventory		0		0		0
Cash Value Life Ins.						
Other Asset not allowed		0		0		0
Other Asset allowed		0		0		0
Total Non-Current Assets	2,100,375	2,747,468	2,303,312	2,885,313	0	0
Total Assets	15,054,786	14,777,456	13,622,821	13,323,379	0	0

Current Liabilities						
N/P - Bank		0		0		0
Equipment Notes	499,210	499,210	501,029	501,029		0
N/P - Related Company		0		0		0
A/P - Trade	2,707,335	2,707,335	1,950,851	1,950,851		0
Due Sub-Contractors		0		0		0
A/P - Related Company		0		0		0
Taxes & Accruals	389,402	389,402	328,493	328,493		0
Billings Excess Costs	895,039	895,039	827,493	827,493		0
Other Liabilities	783,002	783,002	687,200	687,200		0
Other Liabilities (Income Tax)		0		0		0
Total Current Liabilities	5,273,988	5,273,988	4,295,066	4,295,066	0	0
	As Stated	As Allowed	As Stated	As Allowed	As Stated	As Allowed
Non-Current Liabilities						
Equipment Notes	658,023	658,023	542,174	542,174		0
Mortgages on Real Estate	1,589,445	1,589,445	1,610,139	1,610,139		0
Deferred Taxes		0		0		0
Other Liabilities no as allowed		0		0		0
Other Liabilities allowed		0		0		0
				0		0
Total Non-Current Liabilities	\$2,247,468	\$2,247,468	\$2,152,313	\$2,152,313	\$0	\$0
Total Liabilities	7,521,456	7,521,456	6,447,379	6,447,379	0	0
Preferred Stock		0		0		0
Common Stock		0		0		0
Paid In Capital		0		0		0
Retained Earnings		0		0		0
Other Comprehensive Income		0		0		0
Treasury Stock		0		0		0
		0		0		0
Owner's Equity	0	7,256,000	0	6,876,000	0	0
Total Liabilities & Equity	7,521,456	7,256,000	6,447,379	6,876,000	0	0
Income Statement						
Revenues	52,234,000	52,234,000	48,423,000	48,423,000		0
Cost of Sales (-)	42,394,000	42,394,000	39,488,722	39,488,722		0
Operating Expenses (-)	5,893,020	5,893,020	6,010,393	6,010,393		0
Operating Income	3,946,980	3,946,980	2,923,885	2,923,885	0	0
Other Expenses		0		0		0
Other Income		0		0		0
Earnings Before Taxes (EBT)	3,946,980	3,946,980	2,923,885	2,923,885	0	0
Income Taxes (-)	782,950	782,950	629,402	629,402		0
Earnings After Taxes (EAT)	3,164,030	3,164,030	2,294,483	2,294,483	0	0



Net Quick	7,680,423	6,756,000	7,024,443	6,143,000	0	0
Net Worth	7,533,330	7,256,000	7,175,442	6,876,000	0	0
Quick Ratio	2.46	2.28	2.64	2.43	0.00	0.00
Debt/Equity	1.00	1.04	0.90	0.94	0.00	0.00
Fixed Debt/Equity		0.38		0.39		0.00
Gross Margin %		18.84		18.45		0.00
G&A as %		11.28		12.41		0.00
Revenue/Account Rec		5.45		5.68		0.00
Revenues/Net Quick		7.73		7.88	0.00	0.00
Current Backlog						
Net Quick/Backlog		0.00%		0.00%		0.00%
Net Worth/Backlog		0.00%		0.00%		0.00%
Z-Score		6.26		6.27		0.00
Statement date						
Current Assets	12,954,411	12,029,988	11,319,509	10,438,066	0	0
Non Current Assets	2,100,375	2,747,468	2,303,312	2,885,313	0	0
Total Assets	15,054,786	14,777,456	13,622,821	13,323,379	0	0
Current Liabilities	5,273,988	5,273,988	4,295,066	4,295,066	0	0
Long Term Liabilities	2,247,468	2,247,468	2,152,313	2,152,313	0	0
Total Liabilities	7,521,456	7,521,456	6,447,379	6,447,379	0	0
Equity	7,533,330	7,256,000	7,175,442	6,876,000	0	0
Revenues	52,234,000	52,234,000	48,423,000	48,423,000	0	0
Net Income	3,164,030	3,164,030	2,294,483	2,294,483	0	0
Operating Income	3,946,980	3,946,980	2,923,885	2,923,885	0	0



FUNDS DISBURSEMENT SERVICES AGREEMENT

THIS FUNDS DISBURSEMENT SERVICES AGREEMENT (this "Agreement") is made by and between **SureTec Information Systems, Inc. ("SISCO")** and _____ ("**Contractor**") this _____ day of _____, 2007.

Recitals

- A. SISCO is a corporation organized and existing under the laws of the State of Delaware, with its principal place of business at 9737 Great Hills Trail, Suite 320, Austin, Travis County, Texas 78759.
- B. Contractor is a Corporation organized and existing under the laws of the State of _____. Contractor is engaged in the _____ business and maintains its principal office at _____.
- C. Contractor has procured a contract (the "Contract") with _____ (the "Obligee") for that certain construction activity in connection with the _____ project (the "Project"). Contractor will be required to provide certain labor, material, equipment and/or services described as _____ (the "Work") for the Project. The original amount of the Contract is _____. Contractor's work on the Project is estimated to commence on or about _____ and be substantially complete by _____.
- D. Contractor either has provided, or will provide, performance or payment bonds (the "Bonds") issued by SureTec Insurance Company, (the "Surety"), as surety or co-surety, in favor of Obligee. Surety has conditioned its execution of such bonds on Contractor's use of a qualified funds disbursement program administered by a third party.
- E. SISCO is willing to provide such funds disbursement services on the terms and conditions set forth herein.
- F. Contractor has agreed to pay a fee for SISCO's services (the "Fee") in an amount equal to _____ percent (____%) of the Contract. One-half of the Fee shall be paid to SISCO from the first disbursement hereunder. One-half of the remaining unpaid balance of the Fee shall be paid with each ensuing disbursement. Payment in full of the Fee shall be made by the earlier of the sixth or final disbursement. In addition to the Fee, Contractor shall pay all express/overnight delivery fees as they are incurred. Alternatively, Contractor may provide SISCO with its third party (e.g., FedEx, UPS, DHL, Lone Star) sender's billing information for any deliveries of checks that Contractor desires to be sent by overnight or expedited delivery. The Fee shall be subject to an increase of 7.5% of the Fee for each month, in excess of two months, that the project duration exceeds that set forth in C. above.

Agreements

In consideration of their mutual promises contained herein, and other good and valuable consideration, the receipt and sufficiency of which are acknowledged, the parties hereto agree as follows:

1. **Recitals.** The above Recitals are made a part hereof and are incorporated by reference.
2. **Disbursement Control Account.**
 - (a) Contractor agrees that SISCO will open a checking account (the "Account") at a national bank (the "Bank") to be used for the purposes of disbursing payments hereunder. In the event that SISCO shall change financial institutions, all references herein to "Bank" shall apply to such successor or substitute financial institution.
 - (b) Checks drawn on the Account will be printed with Project name and the name and address of the Contractor. All check stock shall be maintained by SISCO. Checks drawn on the Account, or wire or other transfers from the Account shall require only such signatures of SISCO personnel as SISCO and Bank may from time to time determine. In lieu of signatures, any transfer may be made, ordered, or cancelled online or by phone by SISCO using such Personal Identification Numbers ("PIN's") or password procedures as may be established by Bank and SISCO. Contractor shall not have signatory authority over the Account. Contractor is not, with respect to the Account, a "customer" of the Bank.
 - (c) Contractor agrees that SISCO shall have no responsibility to Contractor for any Bank error or omission in holding or administering Proceeds and other credits deposited into the Account. SISCO and Surety shall not be liable for any loss of the Proceeds or funds on deposit at the Bank occasioned by, arising out of, or in any way connected to the selection of Bank. SISCO assumes no responsibility in the event of any failure of the Bank to honor any item drawn on the Account or to re-credit the Account with any funds drawn improperly on said Account, whether by forged or missing endorsement or the failure of the Bank to exercise commercially reasonable practices in connection with debiting any amount against funds in the Account. SISCO will assist Contractor and Surety in legal pursuits of Bank if necessary to protect the Proceeds.
 - (d) Contractor shall direct Obligee to deliver all Proceeds to SISCO for deposit into the Account. Contractor agrees that any and all Proceeds received or earned by Contractor are assigned and dedicated to, and shall be immediately delivered to, SISCO for the purposes set forth herein. Contractor's directions to Obligee shall be on Letter of Directive form provided by SISCO, substantially in the form of Exhibit "A" hereto and shall be revocable only with the express written consent of Surety.
 - (e) Contractor hereby irrevocably appoints and designates SISCO, and any designee of SISCO, as Contractor's attorney-in-fact with the right, power, and authority, but not the obligation, to receive, collect, endorse, negotiate, and deposit any checks, wire transfers, drafts, or other instruments representing payment of Proceeds by Obligee pursuant to the Contract, to give receipts and releases therefore, to accept and make wire or other transfers, and to do all things necessary to effectuate the intent of this Agreement.
 - (f) The Account shall be used for the purposes set forth herein. Contractor agrees not to pledge, grant a security interest in, assign or otherwise attempt to transfer or convey any Proceeds to any person or entity without the express written consent of Surety. Creditors of Contractor, including

but not limited to: general creditors, secured creditors, judgment creditors, receivers, trustees in Bankruptcy, and any other representatives of Contractor shall have no legal or equitable right, claim, or interest in or to the Account unless and until the Project has been fully and finally completed, all of Contractor's obligations to Surety and SISCO have been fully performed, and Surety shall have been released from liability on the Bonds. SISCO agrees to remit to Contractor, or to its representatives or creditors, as their interests may appear, those Proceeds, if any, which remain in the Account after all Contract obligations have been paid by Contractor, all of Contractor's obligations to Surety and SISCO have been fully paid or satisfied, and all of Contractor's obligations hereunder have been fully and finally performed. Unless and until such conditions have been satisfied, as evidenced by written confirmation thereof by Surety and SISCO, Contractor shall have no right to collect, disburse, or prevent SISCO or Surety from disbursing the Proceeds or funds in the Account in accordance with this Agreement. The consent of SISCO and Surety are express conditions precedent to the right of Contractor to obtain any sum of money from the Account. The rights of Surety and SISCO hereunder are in addition to and in aid of, and not in derogation of, nor substitution for, Surety's equitable, legal, statutory or contractual rights with respect to the Proceeds.

- (g) SISCO shall pay no interest on any funds on deposit at the Bank and assumes no responsibility for the earning of any income thereon. In the event that interest or credit against bank service charges shall be earned on the Account or on the Proceeds, such interest or credit shall accrue to the benefit of SISCO and shall be considered additional consideration earned by SISCO hereunder.
- (h) The Account may be established as a "zero balance" or repurchase agreement account, such that Proceeds on deposit with the Bank shall be separately accounted for, but may be commingled with other funds of SISCO on deposit by means of account transfers, "sweeps," repurchase agreements, or other treasury management procedures.

3. Account Disbursements.

- (a) Prior to any request by Contractor for SISCO to make a disbursement from the Account, Contractor shall deliver, or shall have previously delivered as indicated, to SISCO each of the following:
 - (i) true and correct copies of the Contract, the Contract Documents, the Bonds, and all subcontracts and purchase orders relating to the Work;
 - (ii) any change orders to the Contract or its subcontracts as they are executed;
 - (iii) a "Job Cost Breakdown" in form satisfactory to SISCO and Surety, detailing all estimated costs, overhead and profit, completed accurately by an officer of Contractor;
 - (iv) a true and correct copy of Contractor's current schedule of values or unit prices that Contractor will use or has used as its basis for its request for payment from Obligatee;
 - (v) a true and correct copy of the written pay request to Obligatee, together with copies of all supporting documents required by the Contract (the "Pay Request"), and

- (vi) Contractor's Disbursement Request, as hereinafter described, signed by Contractor and accompanied by copies of invoices and such other documentation to support the proposed disbursement as SISCO may require.
- (b) Contractor shall, periodically in advance of SISCO's receipt of Proceeds, present to SISCO a disbursement request (the "Disbursement Request") stating the name of the payee and the amount of Proceeds requested to be disbursed to the payee. The Disbursement Request shall also itemize all amounts, including cost reimbursements and amount for overhead and profit due to be paid Contractor under this Agreement. Contractor's request for disbursement, whether by Disbursement Request or otherwise, shall constitute a warranty and representation by Contractor that the amounts requested are for costs properly incurred by Contractor for the purposes of fulfilling its obligations on the Project, that there are no other Project costs for the applicable disbursement pay period that have not been disclosed by Contractor in writing, that the Proceeds will be used for the purposes of satisfying Contractor's obligations under its Bonds, and that no undisclosed remuneration, loans, rebates, credits, advances will be made by third party payees to Contractor from the proceeds of such disbursements.
- (c) SISCO may refuse to make any requested disbursement if SISCO or Surety believes, in their sole judgment, that the documentation required to be submitted by the Contractor is incomplete or inaccurate or that the amounts requested are not valid obligations of Contractor or Surety under the Contract or Bonds.
- (d) After review and approval of disbursement requests, and to the extent Proceeds are available in the Account, SISCO will disburse the proceeds for the following purposes, subject to such priority and order or payments as Surety may from time to time establish in the event that there are insufficient funds to pay all requested disbursements:
 - (i) to pay fees or expenses owed to SISCO under this Agreement;
 - (ii) to pay for the cost of the Bonds;
 - (iii) to pay Contractor's direct costs (hereinafter, "Direct Costs") of the Work owed or incurred by Contractor, but not previously paid, to third parties who come within the definition of a "claimant" under any payment bond issued by Surety on the Project or which are reasonable and necessary for the actual performance of the Work. Direct Costs include costs of materials, supplies, and materials incorporated in the Work, non-affiliated subcontractors, suppliers, and vendors; costs of temporary facilities and supplies; rental charges of necessary machinery and equipment owned by others, permit fees, and insurance related to the Project;
 - (iv) to pay or reimburse Surety for any loss, cost, or expense relating to the Project or any other project bonded by Surety on which Contractor is a principal or indemnitor, or for any sums due Surety by Contractor under any agreement of indemnity;
 - (v) to establish reserves against or for asserted liens or stop notices and claims of others that are disputed by Contractor, or for warranty or warranty, punch list, or maintenance obligations under the Contract;
 - (vi) to reimburse Contractor for direct labor employed at the job site and, if approved by Surety, reasonable job site supervision of persons who are assigned to the

Project. Labor for executives, principals and owners of the Contractor, and home office personnel will not be reimbursed, other than as part of home office overhead expense, as set forth below. Labor costs will be reimbursed at gross payroll cost plus burden, unless Surety requires the separate disbursement of benefits and taxes related to the payroll. When reimbursed as gross payroll plus burden, Contractor shall hold all funds in excess of net payroll in trust and as a fiduciary with the responsibility to immediately transmit such benefits and taxes to the appropriate entity or taxing authority.

- (vii) to reimburse Contractor for Contractor's Direct Costs of the Work paid by Contractor to third parties;
 - (viii) to reimburse Contractor for the use of contractor owned equipment, at such rates and subject to maximums and conditions as the Surety may approve;
 - (ix) to reimburse Contractor for the use of materials used from Contractor's inventory at such prices and subject to such conditions and inventory documentation as the Surety may approve;
 - (x) to pay subcontractors or vendors of Contractor who are affiliated with, or commonly owned by or with, Contractor or any of the Indemnitors of Contractor in its agreement with Surety, only if agreed upon in advance by Surety, and only then on such terms and subject to possible disbursement requirements, as the Surety may require;
 - (xi) to pay or reimburse Contractor's home office overhead expense as described below;
 - (xii) to pay Contractor's profit as described below; and
 - (xiii) for such other purposes and in such other priorities as Contractor, Surety, and SISCO may hereafter agree in writing
- (e) Payments for Contractor's home office overhead and profit shall be based on a percentage of the costs incurred in performing Work on the Project. Unless Surety otherwise consents, "percentage of completion" shall be the lesser of (i) the percentage of total contract funds received from the Obligor, or (ii) the percentage of total costs paid in relation to total estimated costs in the Contractor's Job Cost Breakdown. Contractor recognizes and agrees that "billings in excess of costs" (Proceeds received on a project in excess of the project costs and allocable overhead and profit) will remain on deposit in the Account until used to pay costs, overhead or profit, or until the Account is finally closed. Overhead and profit figures used to compute Contractor's reimbursement for overhead and profit will not be adjusted upwards for favorable buy-out, favorable productivity, or changes in the estimated costs, after work has begun without the express written consent of Surety.
- (f) Contractor shall not request disbursements, other than the final Disbursement Request, which would reduce the Account balance below \$250.00; as such minimum amount is to be available to pay bank service charges that may accrue between disbursements.

- (g) Disbursement will be delivered to Contractor at Contractor's place of business for Contractor's distribution and delivery to the payees.
- (h) Contractor agrees that it shall secure customary written waivers of mechanics' liens or bond claims from the payees to the extent of payment disbursed and promptly deliver the written waivers to SISCO. Further disbursements to Contractor and to its vendors may be withheld if the required waivers are not provided. Interim lien waivers will generally not be required for payments under \$2,500.00, but may be required at the option of SISCO or Surety.
- (i) SISCO will not be obligated to disburse funds until such time as it has verified as finally collected by Bank, the funds deposited to the Account. Contractor is aware that such collection process and the time to verify same, may take three to five banking days, or more. Contractor has been advised that the collection process can be expedited if the Contractor arranges for the Obligee to wire or ACH transfer Proceeds to the Account or deliver Proceeds in the form of a cashier's check.
- (j) SISCO agrees to process disbursement requests as promptly as possible. Contractor should make every effort to forward disbursement requests and backup information at the same time that Contractor submits its Pay Request to Obligee, thus providing SISCO, in a typical situation, with at least 5 business days of processing time before Proceeds are anticipated to be received.
- (k) SISCO may relax or waive any of the disbursement requirements when it considers same to be necessary or desirable to further the satisfactory completion of the Project, but the waiver or relaxation of such requirements on one or more occasions shall not constitute a waiver of SISCO's rights to require strict compliance with the disbursement procedures set forth herein.
- (l) Final disbursement of all funds remaining in the Account after completion of a Contract shall be made only after Contractor has furnished final lien releases by all subcontractors and major vendors, the deadline for filing liens and claims against the Bonds has passed, Contractor has furnished SISCO with documentation of acceptance of the Project, all outstanding claims and disputes in connection with the Project have been resolved, and Surety has given its express written consent thereto. Such disbursement shall generally be made no sooner than 30 days following final completion and acceptance of the Project.
- (m) Contractor agrees that SISCO, upon written request received from Surety, may, at any time, with or without notice to Contractor, deliver to Surety, or to those whom Surety may designate in writing, any and all Proceeds then on deposit in the Account.
- (n) Reimbursement and payment may be withheld or deferred in whole or in part when, in the opinion of the Surety or SISCO, insufficient funds remain in the Account, or to be drawn under the Contract, to satisfy current and future obligations of Contractor to Surety or under the Bonds.
- (o) In the event that Surety has requested, as evidenced by an Addendum attached hereto, "hold back" or additional retainage withheld on profit, overhead or Contractor reimbursements, the deposit of collateral as additional working capital or collateral, special handling of payroll or payroll taxes, or other special treatment of the Proceeds, disbursements shall be made as provided in such Addendum.
- (p) In the event that this Agreement is executed after work on a Project has begun and Contract sums have been paid to Contractor, Contractor agrees to account to SISCO for all Proceeds previously received by Contractor and all costs previously paid by Contractor in connection with the Project.

(q) In the event that Contractor has more than one account or project administered by SISCO for a single surety under this Agreement or under separate agreements, SISCO may, at the direction of Surety, transfer funds between such accounts, make disbursements from other accounts for costs on the Project, or make disbursements from the Account to pay costs on the other projects. Contractor grants to SISCO and Surety a security interest in all such funds and all proceeds and accounts receivable of all obligations bonded by Surety, such that funds from each project shall cross collateralize Contractor's obligations hereunder, under all other such agreements, and all of Contractor's obligations to Surety. SISCO and Surety shall have rights of offset among and between any and all Accounts. Such security interests are in addition to, and not in derogation of or substitution for, all other legal and equitable rights of Surety to contract funds and proceeds.

4. Verification Rights. Contractor understands and agrees that SISCO may contact the Obligor, Surety, Contractor's vendors, and others, including, without limitation, Contractor's employees, to whom SISCO, in its sole discretion, believes Contractor owes or may owe obligations with respect to the Project to verify information or to obtain information regarding Contractor's obligations or performance thereof. Contractor understands and agrees that SISCO may contact Obligor for the purposes of confirming instructions regarding the direction and delivery of Proceeds, the status of Contract payments, and the Status of the Work. Contractor further consents to SISCO's release of all information obtained by it, including information regarding the status of the Account, to Surety at Surety's request. SISCO has the right, but not the duty, to inspect or to have inspected periodically the Contractor's books, records and documents relating to or concerning any aspect of the Project, and Contractor agrees to permit such inspection at the Contractor's business or project offices during normal business hours.
5. SISCO's Duties. SISCO shall disburse Proceeds from the Account, if properly requested by Contractor or Surety, for the purposes set forth herein. SISCO shall not be obligated to Contractor to approve any disbursement or see to its proper application for the benefit of Contractor. SISCO shall not be responsible to Contractor for any failure on its part or the part of others to make disbursements from the Account or to take any other action within the time requested by Contractor. SISCO assumes no duties towards and shall not be liable to Contractor, its subcontractors or suppliers with respect to any of Contractor's obligations arising from or by virtue of the Project. SISCO shall not be asked or required to make any deposit of its own funds into the Account. SISCO shall furnish Contractor with reconciliation reports, and periodic reporting of the status of the Account. Copies of microfilm images of cancelled checks maintained by the Bank will be furnished by SISCO, upon request and payment of any Bank search or reproduction fees. SISCO shall account to Contractor and Surety for all funds received and disbursed and shall make its records and bank account records relating to the Account available to Contractor and Surety for audit and inspection.
6. Compensation of SISCO. Contractor agrees to pay SISCO for its performance of this Agreement the Fee set forth in the Recitals above. If SISCO is required to perform additional services or incur additional expenses other than those defined herein, Contractor shall pay SISCO for time spent by SISCO personnel in connection with such services.
7. Dispute Resolution. All claims, disputes and other matters in question or controversy arising out of, or relating to, this Agreement or the breach or alleged thereof, and all claims by any person or entity seeking the benefits hereunder, shall, at SISCO's election, be decided by arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association then in effect. The locale of any such arbitration shall be in Austin, Travis County, Texas. The hearing shall be before a single arbitrator if the amount in controversy is less than \$250,000, and before a panel of three arbitrators if the amount in controversy is \$250,000 or more. The single arbitrator, and at least one

member of any three member panel, shall be an attorney, licensed in the State of Texas, whose practice is primarily construction or surety related and who has had twenty or more continuous years of practice, either in-house or as law firm counsel, predominantly in those fields. The award rendered by the arbitrators shall be final and judgment may be entered upon it in any court having jurisdiction thereof. The arbitrators are hereby empowered to include in any award the attorney's fees, expert fees, and costs as they may deem appropriate.

8. **INDEMNIFICATION AND LIMITATION OF SISCO'S LIABILITY.** TO THE FULLEST EXTENT PERMITTED BY LAW, CONTRACTOR AGREES TO INDEMNIFY, DEFEND, AND HOLD HARMLESS SISCO AND SURETY, THEIR SUBSIDIARIES AND AFFILIATES, AND THE OFFICERS, EMPLOYEES, AGENTS, REPRESENTATIVES, AND INSURERS AND REINSURERS OF EACH, FROM AND AGAINST ANY CLAIMS, SUITS, OBLIGATIONS, DEMANDS, LIABILITIES, ATTORNEY'S FEES, PENALTIES, CAUSES OF ACTION, COSTS, EXPENSES, JUDGMENTS, AND FINES, ARISING FROM THE ALLEGED OR ACTUAL WRONGFUL OR NEGLIGENT ACTS OR OMISSIONS OF CONTRACTOR OR CONTRACTOR'S OFFICERS, EMPLOYEES, AGENTS, OR REPRESENTATIVES OR OF ANY PERSON OR ENTITY WHO MAKE CLAIM AGAINST SISCO OR SURETY ARISING OUT OF OR IN ANY MANNER RELATING TO THIS AGREEMENT OR THE SUBJECT MATTER THEREOF. SUCH OBLIGATION OF INDEMNITY SHALL INCLUDE THE OBLIGATION TO INDEMNIFY, DEFEND, AND HOLD HARMLESS SISCO AND SURETY, THEIR SUBSIDIARIES AND AFFILIATES, AND THE OFFICERS, EMPLOYEES, AGENTS, REPRESENTATIVES, AND INSURERS OF EACH, IRRESPECTIVE OF WHETHER THE ACT OR OMISSION COMPLAINED OF IS ALLEGED TO BE THE RESULT OF A NEGLIGENT ACT OR OMISSION BY ONE OR MORE OF SUCH INDEMNIFIED ENTITIES, OR WAS CONTRIBUTED TO BY SUCH ENTITIES, SO LONG AS THE SUCH ACT OR OMISSION BY SUCH INDEMNIFIED PARTY OR PARTIES IS NOT THE SOLE CAUSE OF THE HARM COMPLAINED OF. IN THE EVENT THAT SISCO SHALL BE FOUND LIABLE TO CONTRACTOR OR SURETY FOR THE BREACH OF ANY OF ITS OBLIGATIONS HEREUNDER, OTHER THAN MISAPPROPRIATION OF FUNDS, SISCO'S AGGREGATE LIABILITY TO ALL SUCH PERSONS AND ENTITIES SHALL NOT EXCEED, AND IS EXPRESSLY LIMITED TO, THE FEE PAID TO SISCO HEREUNDER.
9. Disclosure of Terms and Contractor's Performance. Contractor recognizes that SISCO may be required to disclose the terms of this Agreement to Oblige, Bank, Lenders, Surety, vendors, subcontractors, and third parties in furtherance of the purposes of this Agreement. SISCO will keep Surety generally advised of the progress on the Project, the status of the Account, and of any issues that SISCO determines to be material to the performance of this Agreement. Contractor recognizes that such reports may contain impressions and subjective determinations of Contractor's performance on the Project and with respect to its performance of this Agreement. Absent a finding of intentional bad faith with intent to harm, SISCO shall not be liable for any comments, statements, or reports so made.
10. Benefit of Agreement. This Agreement is entered into for the benefit of SISCO and Contractor and Surety, such benefits to Owner and Surety being expressly subject to the conditions, terms, and limitations of liability set forth herein. No benefits, rights of action or standing to sue shall accrue hereunder to or for the benefit of any other person or entity. Without limiting the generality of the foregoing, no right of action, claim, or standing to sue shall accrue hereunder to or for the benefit of any vendor, supplier, subcontractor, or creditor of Contractor supplying goods, services, labor, or materials to or through Contractor on the Project.
11. Termination. Contractor may not terminate this Agreement without the express written consent of the Surety, which consent may be withheld so long as Surety has any liability on any bonds or obligations

for Contractor. SISCO may terminate this Agreement upon notice to Contractor and Surety, and in accordance with directions received by Surety as to the disposition of any remaining Proceeds.

12. Non-Waiver. No action or failure to act by SISCO shall constitute a waiver of any right or duty afforded it by this Agreement, at law, or otherwise, nor shall such action or inaction constitute approval or acquiescence of any breach by Contractor hereunder, except as may be specifically agreed in writing.
13. Disbursement Processing Not to Constitute Notice Under Bond or Lien Statutes. Information regarding amounts due vendors, copies of invoices, purchase orders, subcontracts, lien notices, stop notices, and similar information furnished by Contractor to SISCO in connection with this Agreement is for the purpose of facilitating SISCO's performance of this Agreement only, and shall not be considered notice of any such indebtedness to SISCO or Surety for the purposes of any bond or lien laws. SISCO shall not be obligated to forward such information to Surety, unless specifically requested to do so by Surety. Knowledge of such information by SISCO shall not be imputed to Surety for any purpose. In the event that any of Contractor's vendors, suppliers, or subcontractors should elect to avail themselves of rights under applicable lien or bond laws requiring notices to sureties, such notices must be sent directly to Surety or such other parties as the Bonds or applicable law requires.
14. No Garnishment, Attachment, or other Legal Processes against the Account by Creditors of Contractor. Funds in the Account are not an indebtedness of Bank to Contractor, nor are the funds in the Account property or effects of Contractor within the meaning of statutes and Rules of Civil Procedure relating to writs of execution, attachment, garnishment, receivership, and other actions that a creditor of Contractor might seek in an effort to collect a debt from Contractor.
15. Amendment and Counterparts. This Agreement is binding on the parties and their respective successors and assigns and may be amended only by a writing executed by them. The parties may add additional projects and accounts to this Agreement and all terms and conditions hereof shall apply to such additional projects and accounts. This Agreement may be executed in counterparts each of which shall be considered an original but all of which together shall constitute a single agreement. A facsimile signature may be treated as an original signature and a facsimile copy may be treated as an original.
16. Applicable Law. This Agreement shall be governed by, and construed under, the Laws of the State of Texas without regard to its laws that would apply the law of any other state. All performance required under this Agreement shall take place in, and be wholly performable within, the State of Texas. The mailing, phoning, emailing, wiring, or delivery of checks or documents from Texas to other states, including the states of domicile of Contractor or of the Project, shall not constitute the conduct of business in those states, nor subject SISCO to the jurisdiction of the courts of those states. Contractor shall be liable to reimburse SISCO all costs and expenses, including attorneys' fees (whether in-house or paid to outside counsel) and expert fees in defending, whether or not successful, any attempt by Contractor or any of Contractor's creditors to subject SISCO to the jurisdiction of the courts of any State other than those of the State of Texas or of the United State District Courts in the State of Texas.
17. Savings Clause. Wherever possible, each provision of this Agreement shall be interpreted in a manner as to be effective and valid under Applicable Law. If, however, any provision of this Agreement, or portion thereof, is prohibited by law or found invalid under any law, only such provision or portion thereof shall be ineffective, without in any manner invalidating or affecting the remaining provisions of this Agreement or valid portions of such provisions, which are hereby deemed severable.
18. Notices: All notices required to be sent under this Agreement shall be sent to the addresses set forth in the Recitals above.

19. Complete Agreement. This Agreement constitutes the entire agreement and understanding between the parties with respect to the subject matter hereof and supersedes any prior agreements or understandings between them relating to the subject matter hereof.

IN WITNESS WHEREOF, the parties have signed and delivered this Agreement, effective as of the date first above written.

SureTec Information Systems, Inc.

By: _____
Steve Nelson
President

By _____

Its _____

EXHIBIT "A" to FUNDS DISBURSEMENT SERVICES AGREEMENT

[Contractor's Letterhead]

<Date>

<Obligee Name>
Attn: <NAME>
<Address 1>
<Address 2>
<City, State, TX>

Re: Project:
Contract Amount:

Dear <NAME>

We request that you send all contract proceeds earned and to be earned under our contract with you directly to our project disbursing administrator, SureTec Information Systems, Inc. at the following address:

<Contractor>
C/O SureTec Information Systems, Inc.
Attn: Funds Disbursement Dept.
9737 Great Hills Trail, Suite 320
Austin, Texas 78759
(866) 732-0099

Your checks will still be made payable to us. This directive may only be changed by written consent of our surety, American Contractors Indemnity Company. Your signature below, indicating your agreement to make payment in this manner, is a condition to our surety's execution of our performance and payment bonds on this project.

Thank you for your cooperation in this regard. You may receive a follow up phone call or e-mail from SureTec to confirm these instructions and answer any questions you may have.

We are looking forward to a very successful project.

<CONTRACTOR>

<OFFICER>
<TITLE>

cc: SureTec Information Systems, Inc.
American Contractors Indemnity Company, Attn:

Owner/Obligee's Agreement and Acknowledgment:

We acknowledge receipt of the foregoing directive and agree to send payments to SureTec Information Systems, Inc. unless otherwise directed by American Contractors Indemnity Company. By agreeing to make payment in this fashion, we are not waiving nor modifying any of our rights under our contract.

Owner/Obligee: <Obligee's Name>

By: _____ ***date***
Authorized Representative

Typed or Printed Name

Title

Phone Number / email address