



Opinion: How and Why It's Important to Keep the Surety Informed

It is important for the principal to communicate sooner rather than later when hiccups begin to emerge.



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THIS ARTICLE IS offered to help bond producers and their small contractor clients address surety-related questions that may arise during performance of a construction project. Let's assume the bonded small contractor (principal) is performing a project on which the owner (obligee) issued a notice to proceed some nine months ago. Let's assume further that problems have started to emerge on the project. Think generally in terms of performance and payment issues such as schedule delays, differing site conditions, costly changes, personnel difficulties, slow payment on invoices, and the like. Let's say tensions are on the rise and the small contractor, as the principal, is starting to get worried. However, the obligee has issued no deficiency notices yet.

The small contractor believes the obligee is at least partially responsible for the way things are going, and the contractor is looking into a variety of options to resolve the situation. Among other things, the small contractor is contemplating the pros and cons of contacting the surety in an effort to head off further tension before the situation gets out of hand. Following are some of the questions with which the small contractor may be wrestling:

Questions for the Surety

How appropriate is it for the principal to notify the surety of problems on the project in anticipation of complaints or even a formal claim by the obligee? How far in advance of a claim by the obligee would the surety find such communications acceptable?

As a general rule, sureties welcome contact from the principal at any time. That said, who specifically to contact may not be apparent, as different personnel within the surety may play different roles in providing assistance, depending on the matter in question. The surety's bond producer or broker is typically the principal's first, and many times only, point of contact for most projects. It's usually best to start there, as he or she will likely have contacts who may be able to provide input or assistance.

The bond producer or broker is typically in a good position to facilitate contact with someone in the surety claims department with good insight about how to get an obligee moving on things like requests for information (RFIs), change orders, or slow payment. There may also be someone in the claims department who can act as a neutral party to help ensure that the obligee understands its duty to follow the terms of the contract and timely respond to requests from the principal. Many sureties also have in-house engineers

or reasonably priced construction industry consultants with specialized expertise to analyze and assist with other technical problems that may need attention.

It is important for the principal to communicate sooner rather than later when hiccups begin to emerge. As a small business, the principal is often afraid to "push" the obligee in fear of retaliation or the risk of not gaining future projects. However, with the surety's help, the principal may be able to nudge communications with the obligee in a positive direction to de-escalate tension. The right time to speak up is when the principal starts having questions about how the obligee is managing the project, or when difficulties arise in keeping up with payments to laborers, subcontractors, or suppliers.

In what ways can the principal expect its relationship with the surety to change or evolve upon notification of problems on the project?

A positive principal-to-surety relationship depends not only on the ability to understand when to contact the surety, but also what to discuss when contact occurs. The more information the principal provides to the surety, the more effectively the surety will be able to respond. When contact is made, the small contractor should ask lots of questions and be open about issues. Glossing over concerns while painting only a positive picture likely will not help in the long run, as the surety will not be able to provide on-point input. Further, if the surety eventually comes to understand that the principal was not upfront with information, this could negatively impact the relationship.

With accurate information from the principal, sureties can provide help as early as the bid review stage. Different sureties and brokers provide different services, sometimes at little or no cost to the principal, to assist in facilitating success at all stages of contract performance. Even

in tough situations where it is determined that the principal is too small to work as a general contractor, the surety may be able to help with a business plan more suited for work as a specialty trade contractor. That said, unless the principal asks, the surety will not know what help may be needed.

The spectre of the general indemnity agreement (GIA) is often another reason why the principal may delay contacting the surety. (The GIA is discussed in more detail later.) Many times, the principal does not want to involve the surety for fear of losing its bonding or incurring liabilities under the GIA. When thinking in this way, the principal should understand that putting off addressing issues will likely not be helpful. Again, early, forthright communication is typically the best way for the principal to foster good relations and to obtain the surety's help when needed with such issues.

What role can the principal expect the surety to take in a situation where the principal believes the obligee is being unreasonable?

From the principal's standpoint, an obligee's unreasonableness might include acts or omissions that result in excessive delays to the construction schedule, costly changes to the work, slow payment on invoices, and the like. Keep in mind that the obligee may believe its actions to be reasonable, depending on the specific circumstances of a particular case. It's important for the principal to understand that surety involvement is important when such issues arise.

The surety's role is not to pick sides but to meet the obligation under the bond to facilitate successful completion of contract obligations. If the surety determines that the obligee is indeed being unreasonable, it may work with the principal to ensure that the principal is documenting its position and placing the obligee on notice of its concerns. Documentation is

critical, because the surety is more useful when the principal, in a timely manner, correctly maintains a record of project progress, delays, RFIs, change orders, schedule conflicts, and the like. The surety may also discuss with the principal what steps it should take to alleviate delay damages or other costs if the obligee refuses to pay invoices.

If the obligee threatens to replace the principal with another contractor, the surety can help communicate to the obligee that, even though it wants another contractor to complete, the principal must actually be in default of the contract for the performance bond to be triggered. Helping the parties to understand the real cost of non-cooperation or unreasonableness is a role the surety often plays in moving the parties towards resolving their differences. The principal should understand in such situations, however, that it is not the surety's role to provide legal advice; nor can the surety dictate what to do or not do. The principal should consider hiring its own attorney to assist in weighing tough decisions and in understanding associated legal ramifications.

In what ways can the surety help if cash-flow difficulties occur?

Examples of cash-flow difficulties on a project may arise from slow progress payments by the obligee, disagreements over differing site conditions, disputed or insufficiently funded change orders, schedule delays, performance mistakes, and the like. Financial assistance to cover such issues is never simple. The principal needs to understand that the surety is not a bank and is not always guaranteed the same assignments as a bank.

The earlier the surety is involved when cash-flow difficulties emerge, the more likely there will be success in the outcome. As with any other project-related issue, the surety will want documents, information, and

the appropriate level of access to complete an analysis of all the principal's projects along with the principal's and indemnitor's finances. The surety wants to learn where the issues are.

If the surety determines that its financial assistance is appropriate, it will possibly require collateral or some other assurance that it will be reimbursed. There may possibly be someone else who could become an indemnitor or a real property asset that could prove useful as collateral. The takeaway here is that, the earlier the surety is involved, the greater room there is to be creative in reaching a workable solution.

Given the general nature of the GIA, what assurances does the principal have that requesting early assistance from the surety will not result in a legal claim for damages sometime down the line?

The GIA was mentioned earlier. It is important to understand the connection between the surety bond and the GIA. On one hand, the bond spells out what the surety guarantees to the obligee in the event of default by the principal. On the other hand, the GIA spells out a promise by the principal to compensate the surety for any losses it may incur in making the obligee whole after default. If things go so badly on the project that the obligee terminates the principal and submits a claim, the surety will often assert a contractual right of subrogation through the GIA to pursue the defaulting principal for the costs incurred to takeover or to hire another contractor to complete the work.

While the surety's intent in requiring the GIA is strictly to limit its losses in the event of a default, the principal may see this document as a barrier to open communications when problems arise on the project. The principal may worry that the surety may later use such

communications to pursue legal action for damages under the GIA.

The principal should always take care to read and examine the GIA, understand its connection to the bond, and understand the rights and obligations it embodies. The principal should consider retaining its own legal counsel to help with its assessment and understanding of the GIA. A key element for the principal to be conscious of is that the surety generally has a far greater interest in seeing the principal complete the project successfully than in pursuing legal action for losses triggered by default. Comprehending the surety's interest in the principal's success should encourage the principal to seek early input when problems arise before such problems escalate or become too difficult to cure. The GIA should not be viewed as a reason to avoid early and forthright communications with the surety.

If the bond is guaranteed under the U.S. Small Business Administration (SBA) Surety Bond Guarantee (SBG) Program, what risk is there that the surety will favor terminating the principal instead of providing assistance when problems emerge on the project?

The SBG Program incentivizes sureties to issue bonds to small businesses that would otherwise not meet traditional underwriting standards. Its purpose is to mitigate the potential losses that the surety would incur on bonds issued to small businesses that end in default. Upon default, the financial detriment to the surety on an SBA-guaranteed bond is typically quite a bit less than it would be on a non-guaranteed bond. That's because the surety can submit a claim to the SBA for reimbursement of a "guarantee percentage" of the incurred loss. The guarantee percentage can be 70%, 80%, or 90%, depending on regulatory and

technical factors managed by the SBA and pre-agreed to by the surety.

Small businesses have been known to express suspicion regarding the surety's motivation to assist the principal on SBA-guaranteed contracts. Some worry that the surety might favor the obligee's decision to terminate, possibly believing that might be quicker and possibly less costly than the time and effort it might take to aid the principal.

The notion that sureties are not interested in helping the principal when problems arise on a project is simply unfounded. Sureties have a reputation to protect for successful completion of their projects, and a high SBG Program claim rate would work against that reputation. Further, sureties are interested in long-term successful client relationships. The surety's access to loss mitigation under the SBG Program is no reason for the principal to delay seeking help when difficulties arise on the project.

What can the principal expect from the surety once the obligee issues a notice of termination and submits a claim on the performance bond?

Surety bonds can be tricky, as some bonds may be triggered with just a default while others require termination. The principal should carefully examine the wording of the bond to understand how a claim is triggered. It is typical for the obligee to issue a notice of default along with an opportunity to cure before proceeding to termination. Many times the obligee will copy the surety on the cure notice. The principal would be wise to pursue cooperation with the surety at this point, if not before. Even if the obligee does not copy the surety on the cure notice, the principal's initiative in notifying the surety of the situation could prove useful to avert a final termination.

If the obligee terminates the principal and makes a claim against the performance bond, the surety will

correspond with both the obligee and the principal to gain a full set of documents and facts regarding what happened to cause the obligee to terminate. The surety will likely talk with both the principal and obligee together in order to eliminate a he-said/she-said scenario. Depending on the circumstances, the surety may find a reason to see if the parties can work out the issues with the obligee, ultimately rescinding the termination under specified parameters. When this is done, however, the principal needs to be careful that the obligee's demands remain within the parameters of the contract, so that the principal does not agree inadvertently to something beyond its obligations. The principal would be wise to seek the assistance of independent legal counsel in such situations.

Final Thoughts

This article has touched on several questions that a small contractor may have about getting the surety involved when performance of a bonded construction contract runs into problems. It's not unusual for a contractor, as the principal on the bond, to worry greatly about what will happen if notification is made to the surety about emerging difficulties with the obligee. Uncertainty and worry may cause a principal to delay contacting the surety, which may make things worse in the long run.

The principal's big temptation might be to try resolving matters before the surety has knowledge of them. The risk with this attitude is that the delay in notifying the surety may create a greater likelihood of default and deeper liability problems down the line. It pays for the principal to recognize that the surety can be of considerable assistance, especially when notified sooner rather than later about emerging problems. Early notification gives the surety time to gather the facts, assess the situation, assist the principal in its communications with the obligee, and provide creative input and/or services to help resolve issues. Each situation is unique, and there are no one-size-fits-all answers to the questions that the principal may have in the midst

of rising tensions on the project. The suggestions in this article should hopefully give the principal some encouragement. When problems emerge on the project, the interests between the surety and the principal usually are far better aligned if the principal initiates early and open communication. ●

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