

Trust But Verify:



Prequalifying Project Owners and GCs

MUCH ATTENTION IS given to qualifying potential surety bond principals, where underwriters examine a contractor or subcontractor's capital, capacity, and character to determine single and aggregate bonding lines of credit. What about the other party to the bonded contract—the obligee? The project owner may be public, and dependent on legislative appropriations or agency procedures, or private, and dependent on self-financing resources or a construction loan. Those concerns flow down in the case of a general contractor/obligee on a subcontractor's bonds.

Does the surety care if the obligee can pay its principal? Nonpayment when due usually is a defense to further performance and suspends the contractor's duty to keep working. That is, unless the contract provides that the contractor must continue performing even in the event of a dispute, and the owner asserts a "dispute" that really is motivated by cash-flow problems. Of course, a contractor who cannot get paid usually cannot pay downstream obligations, leading to subcontractor and supplier payment claims. Does the work slow down because of payment issues, or does payment become an issue because the work is falling behind schedule? For the

surety, neither alternative is positive, and both can become expensively entangled in competing delay claims.

Prequalifying the obligee is the primary means of evaluating the risks of an undercapitalized payor or contingent or inadequate construction financing. If the contract to be bonded incorporates the American Institute of Architects' A201 General Conditions (2017), the contractor is entitled to request "reasonable evidence" from the owner that the project is financed adequately. (Section 2.2.1.) What is reasonable will depend on the circumstances of the owner and the project, but the contractor is due an extension of



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the contract schedule if the owner delays in producing that evidence. If the contractor is worried about straining its relationship with the owner by making the request, the surety can take responsibility as part of its underwriting process. As additional protection, the contractor is allowed to request updated or additional financial information if payments are late or the scope of work changes substantially and creates “reasonable concern” during performance. (Section 2.2.2.) Unless the information is provided within 14 days, the contractor can demobilize and charge the owner for the costs once assurance is forthcoming.

How does this process work for a bonded subcontractor? Even though the AIA general contract may be incorporated into the subcontract, the owner is not in privity and won’t be required to provide financial information to its contractor’s subcontractors. The sub’s surety, though, should be able to induce the general contractor to request the information as part of the surety’s underwriting of the subcontract bonds. That is especially critical if the subcontract contains a pay-if-paid clause shifting the risk of owner nonpayment from the general contractor to the sub.

Another factor in prequalifying an upstream obligee is the length and quality of the principal’s experience with that entity. Business relationships can be more important than contractual provisions. A contractor who has dealt with the same owner for a long time, or is in the middle of a multi-phase project spanning years, likely will have fewer problems than one just learning how to deal with its contractual partner. While past performance is no guarantee of future success, how an owner treated the contractor on prior jobs, especially under difficult circumstances, can be telling—unless important personnel have changed, along with the predictability of management. The surety can inquire about the relationship to assist in deciding if these

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intangibles mitigate or increase other financial risks.

What information should the surety seek to increase its comfort level in issuing bonds? The most basic question is the amount of funding available—can the project support not only the initially estimated costs but also “known unknowns” and contingencies? Battle-scarred realism beats starry-eyed optimism. For a self-financed project, the owner will need to provide its capital situation, its debt-service obligations, the magnitude and timing of any other projects being undertaken, and the certainty of its sources of funds for the bonded job. Obtaining this data from the owner’s accounting professional can both reduce the friction of interrogating the owner directly and provide another source of responsibility if the information turns out to be unreliable. Self-financing situations require extra attention to the dependability of the financial details supplied, considering the source.

Construction lending can provide more certainty that the project will be funded as and when required. The lender with a security interest in the property will have strong incentive to see that the construction work is completed and the bills are paid. A key concern for the prequalifying surety is whether the construction

loan has been finalized and closed; commitment letters, preliminary approvals, and other promises mean little until the loan actually closes. Where multiple sources (e.g., loans, grants, other lenders, private contributions, etc.) are involved, additional scrutiny is required. Timing of loan processing and the beginning of construction may require followup by the surety to confirm expectations have been met.

Construction lending in the form of a line of credit carries other concerns. The borrower has much greater control over the funds, which may be diverted from the project. The lender may perform no inspections or analysis of the work completed to sync up disbursements. At least with a loan, the surety can obtain and review the loan documents to learn the structure of the credit and its dedication to the project. Depending on the size and identity of the lender, its own credit strength may be investigated. However, most construction loans do not supply 100% of the cost of the work, with the lender requiring some input from the borrower—a necessary investment that also should be prequalified by the surety.

If the project is government owned, funding may be straightforward or highly complicated. Combined federal and state sources on the same job are common, as are local government authorities, development authorities, housing agencies, special-purpose entities, and other forms of public involvement. On federal projects in particular, funds may be allocated through departmental budgets that are affected by numerous other commitments and not quickly or easily replenished when unexpectedly tapped. With a taxing authority behind the funding obligation, eventual payment is almost certain; but delays, especially in the case of major scope increases, can be lengthy.

The type of owner contracting on the project is very important. Single-purpose entities by definition are tied to the project only and

may lack resources to weather the unexpected. Owners in the form of LLCs, LLPs, and LPs involve multiple individuals or entities whose identities, wherewithal, and obligations should be considered. Even if the owning/contracting entity has obtained financing, breaches by the owner's owners could result in the lender's taking over the project and both delaying and complicating completion of the work. Public private partnerships (PPPs) involve the contractor in more than just the construction phase but usually also managing or operating the project after completion. The complexity of PPPs requires heightened investigation and, most critically, confirmation of the contractor's ability to exit the project under appropriate circumstances.

Other Suggestions for Prequalification

Search the public records for clear title to the property on which the project will be built and for any litigation involving the owner. Also investigate the property value, which may influence whether the owner stays with the project or abandons it due to unexpected difficulties.

Confirm that the contractor, lender, title company, and any other entities involved in the project either are independent of each other or have disclosed any legal or business connections.

Assure that the principal contractor is not being required to contribute to financing the project, either by infusing its own capital, by delaying receipt of payment or "back-loading" cash flow, or even by "soft funding" with

contributions of pre-construction work without contemporaneous payment.

As important as prequalifying the principal contractor, sureties should obtain the information needed to increase the chances that a qualified principal will be paid in full and on time. ●

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Prequalifying Owners and GCs! You will not want to miss this NASBP, ASA, and CFMA ConSure Infocast on January 9, 2025!



Be sure to register [<https://learn.nasbp.org/trust-but-verify-prequalifying-project-owners-and-gcs>] for this valuable webinar on a critical risk management action—prequalifying owners and GCs—provided jointly by NASBP, ASA and CFMA. Save the date for January 9, 2025, at 2:00 p.m. Eastern for the webinar "Trust But Verify: Prequalifying Project Owners and GCs." The presenters—Greg Veal, Partner of the law firm of Bovis, Kyle, Burch & Medlin, LLC, and Rudy Dominguez, Senior Vice President, Claims of Old Republic Surety—will discuss how contractors can prequalify project owners and subcontractors can prequalify general contractors on public and private sector projects. These experienced and knowledgeable legal and surety professionals will captivate you with useful information, and their stories

and anecdotes will illustrate what happens when prequalification has been done well . . . and when it hasn't! Bring your questions and walk away with timely tips you can use to prequalify owners and/or contractors for your next project so you will know with whom you should work or not work. This webinar will be geared to contractor, subcontractor, supplier, and surety professional audiences. Be sure to log in as a NASBP Member, Affiliate, or Associate, or use your specific association's discount code (for ASA and CFMA members) when registering for this ConSure Infocast to make sure you are paying the discounted member rate that is available to all NASBP, ASA, and CFMA members. Note: all registration fees go toward supporting the work and initiatives of NASBP, ASA, and CFMA. #ConSureInfocast