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CONTRACT TERMS AND CONDITIONS FROM A SURETY PERSPECTIVE

A surety on a performance bond guarantees to the project owner that the construction contractor will perform the contract fully, in accordance with its terms and conditions. The nature and scope of what the surety is securing, the performance of the contract, is not set forth in the performance bond form.

The performance bond form is a relatively simple document that is typically one or two pages long. The underlying obligation being secured, the construction contract, usually is incorporated by reference. For example, paragraph one of the A312 Performance Bond promulgated by the American Institute of Architects states:

“The Contractor and Surety, jointly and severally, bind

themselves ... to the Owner for the performance of the Construction Contract, which is incorporated herein by reference.”

Thus, in order to determine its exposure under the performance bond, the surety must review the construction contract. A surety analyzes certain key contract terms to assess the level of risk under the performance bond. Use of construction industry standard form agreements by construction owners offers a convenient and ready contractual framework that facilitates the underwriting process and is well-regarded by surety underwriters.

Key Contract Terms

Contract review is an essential element in the underwriting process and

the surety’s determination of whether to issue the bond. Key contract terms that are important to a surety underwriter’s risk assessment are:

- ▶ Payment terms
- ▶ Time for performance
- ▶ Liquidated damages provisions
- ▶ Termination for default provisions
- ▶ Warranty obligations

Payment Terms

A surety reviews the contract terms to determine whether the contract will provide sufficient cash flow to fund the project. Construction contracts typically provide for monthly payments by the owner in accordance with the contractor’s progress on the work (a progress payment). Typically, the payment provision in the contract requires the contractor to submit an application for payment by a certain day of the month for work performed

in the prior month. The surety reviews this provision to ensure that the contractor is not required to fund the work out of its own capital for an extended period of time. Monthly progress payments generally provide sufficient cash flow to cover costs and overhead incurred throughout the project. A more infrequent progress payment schedule raises the risk that the contractor's cash flow may become strained.

Another element of the payment provision is the retainage clause. Under the terms of the contract, the owner typically retains a percentage of the progress payment (e.g., 10 percent). The owner then releases the retainage upon substantial completion of the project. A surety generally favors a retainage provision because

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it provides financial incentive to the contractor to complete the punch-list items of the contract. At the same time, however, the retainage should be a reasonable amount that does not significantly hamper cash flow on the project.

Two payment clauses that are of interest to the surety when reviewing a contract between a general contractor and subcontractor are a “pay when paid” clause and a “pay

if paid” clause. A “pay when paid” clause generally suspends the general contractor's obligation to pay the subcontractor for a reasonable time while the general contractor attempts to collect payment from the owner. However, nonpayment from the owner generally is not an absolute defense against the general contractor's obligation to pay the subcontractor. A “pay if paid” clause establishes the payment by the owner to the general

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Owner's Headaches

contractor as a condition precedent to the general contractor's obligation to pay the subcontractor. (A number of states have determined the "pay if paid" clause void and against public policy.) A "pay if paid" clause puts the cash flow to the subcontractor at risk and would be a concern to the surety on a subcontract performance bond.

Time for Performance

In writing a performance bond, the surety is making a determination of the contractor's operational and financial viability throughout the term of the project. The longer the term of the project, the further into the future the surety must make a projection about the contractor. Longer range projections become more uncertain, which raises the surety's risk. Thus, the surety seeks a project duration of a reasonable length, such as two years or less. Of course, projects of longer than two years are bonded. However, the project duration is a factor in the surety's risk assessment.

Another aspect in the surety's analysis of the provision regarding time for performance is whether the duration is sufficient for the scope of work, or whether it is unrealistically aggressive. If the time for performance is overly aggressive, the contractor may risk late completion and incur liquidated damages.



Liquidated Damages

Generally, a project owner's damages stemming from a contractor default are the cost of completing or correcting the contractor's work (*direct damages*) and other loss suffered by the owner as a result of the default, such as loss related to delays caused by the default (*consequential damages*). A liquidated damages provision is an agreement by the parties on the dollar amount of damages caused by a default, specifically an inexcusable delay that extends the completion of the contract beyond the completion date. Usually, the liquidated damages are expressed in terms of a fixed dollar amount of damages for every day that the contract extends beyond the completion date.

A surety reviews this provision to determine whether the amount is reasonable and does not expose the contractor to the risk of having to pay

a substantial amount of its liquidity in damages. In fact, courts have held that a liquidated damages provision that does not bear any reasonable relation to the damage that follows a default is a penalty, and penalty clauses are invalid.

Termination for Default Provisions

A termination for default provision sets forth the grounds on which a project owner may terminate the contractor's right to proceed under the contract. Upon termination, the contractor typically is liable for costs incurred by the owner to complete the work in excess of the contract balance. In addition, under a termination for default provision, the owner often has a right to use the equipment and materials on the project to complete the work.

A surety is especially interested in the termination for default provision because it is the trigger to the surety's obligation under the performance bond. A surety desires a provision that provides adequate notice by the owner to the contractor and surety, and provides the contractor an opportunity to cure the default. All parties have an interest to avoid a claim under the performance bond. Providing sufficient notice

“Pay When Paid”—Suspends the general contractor's obligation to pay the subcontractor for a reasonable time while the general contractor attempts to collect payment from the owner.

“Pay If Paid”—Establish the payment by the owner to the general contractor as a condition precedent to the general contractor's obligation to pay the subcontractor.

“ From the perspective of the surety, standard forms generally facilitate the underwriting process because they represent an attempt to establish terms and conditions that are fair and balanced...” ”

and opportunity to cure the default before the surety is called increases the chances that a claim under the bond can be avoided.

Warranty Provisions

Construction contracts typically contain provisions that require the contractor to correct any defective work for a period of time after completion of the project. Such provisions often involve key components of the project such as the HVAC system, roof or windows. The surety is concerned with the duration of the warranty obligation and the scope of the obligation.

As noted above, a surety is concerned with long-term obligations. Sureties are usually comfortable in covering a warranty obligation of up to two years. Durations longer than two years increase the uncertainty regarding projections about the contractor's future viability. Thus, the risk increases and the surety tightens its underwriting standards as to contractors that can qualify for the bond. In addition, sureties are comfortable in covering a warranty obligation that involves faulty workmanship or materials. The surety's risk increases considerably if the scope of the obligation involves performance guarantees (i.e., a warranty that certain building systems will meet performance standards). This type of warranty can make the contractor responsible for design errors.

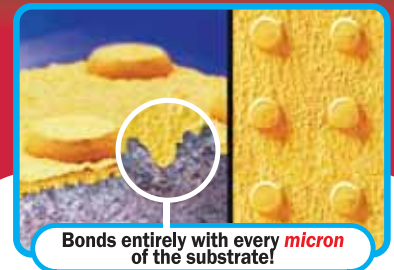
That is, the contractor is promising to provide a system that meets certain standards. As the contractor takes on design liability, its risk increases, and therefore the surety's risk increases.

Benefits of Using Construction Industry Standard Forms

In the construction industry, standard form construction agreements and other documents, such as bond forms, commonly are used by project parties. These forms are developed and promulgated by trade and professional associations, such as the American Institute of Architects (AIA), the Associated General Contractors of America (AGC), and the Engineers Joint Contract Documents Committee (EJCDC). Among the benefits of standard form documents are expediting agreements and reducing transaction costs by allowing parties readily to adopt them, in whole or in part, as the expression of their agreement and by serving as invaluable references for industry-accepted boilerplate and prevailing customs and practices. From the perspective of the surety, standard forms generally facilitate the underwriting process because they represent an attempt to establish terms and conditions that are fair and balanced and because the provisions are familiar to the underwriter.

The organizations that promulgate

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standard form construction agreements typically engage in lengthy drafting processes in which they seek consensus positions on risk issues through sustained dialogue with other organizations representing different stakeholder groups. Each drafting organization then considers the perspectives of and the comments received from stakeholders in an effort to publish fair documents that strike an appropriate balance among the competing interests of project participants.

On September 28, 2007, ConsensusDOCS (www.consensusdocs.org), an initiative spearheaded by the AGC and other leading construction associations, including those representing construction owners (Construction Users Roundtable, Construction Owners Association of America, and National Association of State Facilities Administrators), sureties (The Surety & Fidelity Association of America) and bond producers (National Association of Surety Bond Producers), released a new generation of standard form construction agreements and related documents. The stated goal of the initiative is to develop balanced standard form documents that allocate project risks under a philosophy of what is in the "best interests of the project," not solely the best interests of a single project party.

ConsensusDOCS may represent a unique effort. Approximately twenty associations participated to varying degrees in the drafting process for the standard forms, an unprecedented amount of support and involvement by stakeholder groups, especially prominent trade groups representing construction owners. However, since ConsensusDOCS are "new" forms, they have not had the level of legal commentary and precedents of more

5 Ways Contracts Can Increase Profit

- ▶ Increase the pool of qualified contractors interested in the project
- ▶ Reduce or eliminate an adversarial "ethic" on the project
- ▶ Foster positive project relationships
- ▶ Avoid the inclusion in bids of time and cost contingencies to cover unreasonable or not properly allocated risks
- ▶ Enhance the project owner's business reputation with the construction community

established forms, such as those published by AIA and EJDCDC.

Adopting carefully thought-out and balanced contracts as preferred contract forms may return significant "dividends" for construction owners by:

- ▶ Increasing the pool of qualified contractors interested in the project
- ▶ Reducing or eliminating an adversarial "ethic" on the project
- ▶ Fostering positive project relationships
- ▶ Avoiding the inclusion in bids of time and cost contingencies to cover unreasonable or not properly allocated risks
- ▶ Enhancing the project owner's business reputation with the construction community

These "dividends" may translate into projects having a reduction in total project costs, a lower incidence of project disputes and a shortened project delivery time.

Use of an accepted industry standard form agreement that is not so extensively modified as to eliminate the fundamental balance struck in the original form document also provides sureties with confidence that the project owner has incorporated fair versions of key contract provisions

that do not pose an unreasonable assumption of risk for the contractor and its surety. These include provisions such as those addressing notice, payment terms, damages, termination for default and construction warranties. Moreover, standard forms contain provisions that are familiar to the underwriter, thus facilitating the underwriting process.

Of course, contracting parties always should consider retaining knowledgeable legal counsel to review the form contract to ensure that all terms and conditions are appropriate to the particular needs of the parties and are enforceable in the jurisdiction of the project.

Standard Form Document Example

The principal fixed-priced agreement between the owner and the contractor in the ConsensusDOCS library of forms is ConsensusDOCS 200, which provides a sound framework to craft the parties' contract. ConsensusDOCS 200 integrates the owner-contractor agreement with the general conditions into one document, which addresses important terms and conditions, such as:

- ▶ Owner responsibilities
- ▶ Contractor responsibilities
- ▶ Differing site conditions

- ▶ Changes
- ▶ Delays
- ▶ Payments
- ▶ Warranties
- ▶ Notice provisions
- ▶ Damages (including liquidated damages provisions)
- ▶ Hazardous materials
- ▶ Indemnity
- ▶ Insurance
- ▶ Performance and payment bonds
- ▶ Dispute mitigation and resolution
- ▶ Termination for default and for convenience

Parties must complete the form by inputting project-specific information. Free sample copies of ConsensusDOCS 200 may be obtained at www.consensusdocs.org.

This article has touched briefly upon some of the key construction contract terms that are important

to the surety in making its underwriting decisions and has pointed out how adoption of commonly used construction industry standard form documents can help facilitate the underwriting process, thus enhancing prospects for providing surety credit for the project. ■

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- ¹ John W. Welch, et al., *Contract Surety* 4.22 (American Institute of Chartered Property & Casualty Underwriters/Insurance Institute of America 2d Ed. 2003)
- ² John Anderson, et. al., *Phases of the Construction Project*, in *The Construction Project* 24 (Marilyn Klinger & Marianne Susong eds. 2006)
- ³ Shannon J. Briglia, et al., *Terms Employed in the Construction Project*, in *The Construction Project* 106 (Marilyn Klinger & Marianne Susong eds. 2006).
- ⁴ *Id.*
- ⁵ John W. Welch, et al., *Contract Surety* 2.33 (American Institute of Chartered Property & Casualty Underwriters/Insurance Institute of America 2d Ed. 2003).
- ⁶ *Id.* at 2.34.
- ⁷ See, e.g., *Burns v. Hanover Ins. Co.*, 454 A.2d 325, 327 (D.C. 1982) (citing *Order of AHEPA v. Travel Consultants, Inc.*, 367 A.2d 119 (D.C. 1976)).



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