

# ***A Construction Project Owner's Guide To Surety Bond Claims***

*It's Friday and, as the afternoon creeps into the weekend, you, the project owner, are dissatisfied with the progress of Quality Constructors. It's obvious, with the lack of performance this week, there is no way the project is going to be completed on time!*

*At 3:00 p.m. the phone rings. E-Z Mechanical, the mechanical subcontractor, angrily threatens to walk off the job. Quality Constructors hasn't paid them and they intend to take legal action to file a lien on the project if something isn't done. That's going to go over great with the lenders!*

*There is no choice; it's time to declare Quality in default and call the surety! After all, didn't the surety promise a completed project, free of liens?*

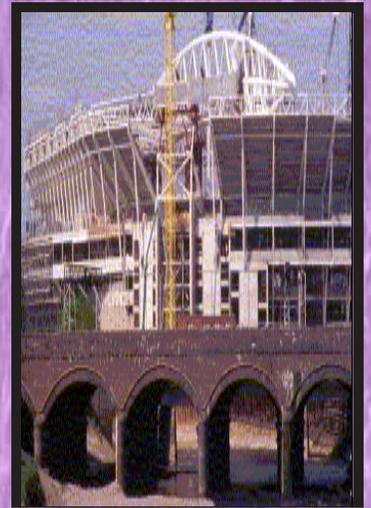
**You are about to experience a surety bond claim.**

## **INTRODUCTION**

The purpose of *A Construction Project Owner's Guide to Surety Bond Claims* is to provide an understanding of the claims process for those who have or are about to become involved in a bonded construction project. Although we always hope our projects will be perfect, sometimes things go wrong. That is one of the reasons owners bond their projects to have someone to turn to when the contractor gets into trouble<sup>1</sup>. The other reason is to have an independent third party, a surety, verify that the contractor is, in fact, qualified to perform the job. This is called prequalification of the contractor. In its underwriting process, the surety evaluates the capital, capacity, and character of the prospective contractor to assure the project owner that the contractor is able to complete the project before the surety commits to provide the bonds.

The corporate surety backs its judgement with its own financial resources. When the surety errs in its prequalification, it pays for its mistake. With \$450 billion of construction performed annually in both the public and private sectors, the prequalification services of the corporate surety are essential to assure that the contractor is qualified and capable of performing the contract. More than 80,000 contractor failed during 1990-1997, leaving a trail of unfinished private and public construction projects with liabilities exceeding \$21.8 billion.

Usually, by the time a claim on the bond is considered something has gone terribly wrong with the project. Prequalification failed, and the owner and contractor are at odds. The atmosphere is charged and tempers are short on every side.



***The purpose of [this booklet] is to provide an understanding of the claims process.***

By using examples, *A Construction Project Owner's Guide to Surety Bond Claims* will help you understand the process, the participants, and the complexities that are a part of every bond claim and *why* things happen during the course of a surety claim.

## DEFINITIONS

The following definitions are presented to provide an understanding of certain terms commonly used in the surety industry.

In the language of the construction industry, the three parties to a performance bond are usually the contractor (principal), the owner (obligee), and the surety.

**Claimant:** A party who has a right to make a bond claim.

**Obligee:** The construction project owner or the party to whom the contractor (principal) is bound under a contract.

**Payment Bond:** A written instrument, generally issued in tandem with a performance bond, whereby the surety is bound to pay certain parties, such as subcontractors or material suppliers, furnishing labor or material to the contractor for use in performance of the bonded contract to the extent provided by the bond or any applicable statute.

**Performance Bond:** A written instrument whereby a surety has undertaken to guarantee that a named principal shall perform in accordance with the terms and conditions of an underlying agreement with the obligee. In essence, the performance bond protects the owner from financial loss should the contractor fail to perform the contract.

**Principal:** The contractor or subcontractor whose performance under a contract is guaranteed to the owner or obligee.

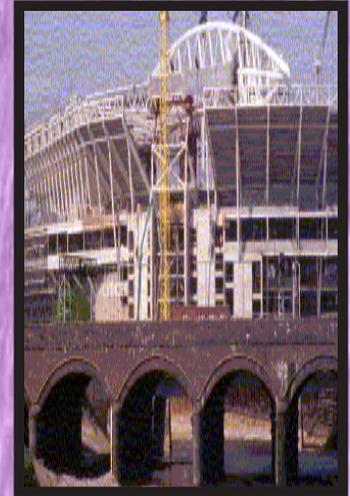
**Surety:** A corporation licensed to provide guarantees to third parties of the performance of its contractor (principal) in discharging the contractor's responsibilities to the owner (obligee).

## PERFORMANCE BOND CLAIM

*The contractor and the surety, jointly and severally, bind themselves, their heirs, executors, administrators, and successors and assigns to the owner for the performance of the construction contract, which is incorporated herein by reference.*

*If the contractor performs the construction contract, the surety and the contractor shall have no obligation under this bond...<sup>2</sup>*

This standard language establishes the obligation of the surety to the owner under the performance bond. In order to understand the obligation of a surety to the owner, you must look at the underlying agreement, the contract, along with approved modifications and authorized changes.



***The three parties to a performance bond are usually the contractor (principal), the owner (obligee), and the surety.***

Since a contract is an agreement binding two parties to accomplish a common goal, there are obligations assumed by each party to the other. As a result, either party may be in breach or default of its obligations to the other.

While the corporate surety guarantees the performance of the contractor, in accordance with the terms and condition of the contract, it also stands in the shoes of the contractor with respect to the obligations that the owner has to the contractor. As an example, the most basic of these contractual rights is the expectation of timely payment from the owner, in accordance with the terms of the contract, for work performed.

## THE CLAIMS INVESTIGATION

The claims investigation is the surety's first action once it has either been placed on notice of an alleged default or learned of a pending action that may place the contractor into default under the contract. The surety's investigation usually will include the following steps:

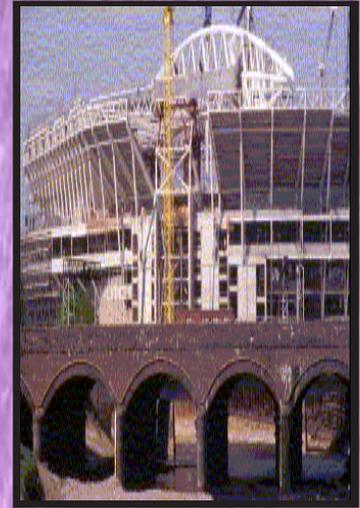
**Contract Review:** The surety will undertake an extensive review of the contract documents to determine the full extent of the responsibility of all parties to each other.

**Contract Progress:** The surety, with the cooperation of both the contractor and the owner, will try to determine what has transpired between those parties. Have both parties operated in accordance with the terms and conditions of the contract and what are the responsibilities, as well as the defenses, of the contractor and surety?

**Legal Position:** Using its own professional legal staff and/or outside counsel specializing in construction and surety law, the surety will evaluate its obligations to both the owner and the contractor.

**Owner:** The duty of the surety to the owner is spelled out in the bond and contract. If its principal has been properly terminated for default according to the terms of the contract, the surety usually is obligated to pay the cost to complete the work less the contract funds still in the owner's hands, but subject to the limit of the bond penalty.

**Contractor:** Since the surety may avail itself of the rights and defenses of the contractor in determining its legal responsibilities to the owner, the surety will take care to avoid any action that would serve to dilute or prejudice any right the contractor may have against the owner. Also, since the surety is guaranteeing the performance of the contractor, the contractor remains liable to the surety for any losses caused by the contractor's failure. Thus, the surety must be sure not to take action to perform the work unless the contractor actually is in default.



***The claims investigation is the surety's first action once it has either been placed on notice of an alleged default or learned of a pending action that may place the contractor into default under the contract.***

It's in the surety's best interest to take prompt action to complete the investigation as soon as possible. Benefits of quick action include:

- It keeps the project moving;
- It will likely save the surety money in the long run;
- It may prevent contractor default; and
- It's good customer service.

Let's go back to the opening scenario that has brought about the declaration of default of Quality Constructors:

*After conducting its investigation, the surety learned that Quality Constructors was not paying E-Z Mechanical and other subcontractors, even though you, the owner, had made payments to Quality for the work performed to date. Quality's president had suffered a severe illness and the interim management team was unable to manage the firm's backlog of work. Quality was experiencing serious financial problems due to severe losses on another un-bonded project and had several hundred thousand dollars in liabilities.*

*After meeting with you, the owner, and Quality Constructors, the surety agreed that your declaration of default was correct and began working to find another contractor to complete the job. The surety also paid E-Z Mechanical and other subcontractors under the payment bond in order to minimize disruption as the project headed toward completion.*

There are several key points in this oversimplified analysis:

1. Although surety bonds are provided by the insurance industry, bonds are a unique type of insurance product. Bonds are a guarantee of one party's performance or payment obligations by a third party, the surety. Most insurance is a two-party contract between the insurance company and the insured.
2. Bonds are contracts. A contract, by its nature, will establish the responsibilities of the parties, in this case the owner and the contractor, to each other. Both parties are compelled to operate within the framework of the contract.
3. If the contractor materially breaches the contract, the surety has an obligation to the owner to complete the work or pay for resulting damages.
4. The surety also has an obligation to consider the contractor's position if the contractor asserts it has not breached the contract.
5. The surety has a right and duty to promptly conduct a reasonable investigation of the owner's allegation that the contractor is in default under the contract.

The process of making a bond claim is governed by the entire body of construction law and precedence associated with the construction industry. The surety must respond to an owner upon notice of default without jeopardizing the rights and defenses of the contractor as it conducts its investigation.

## Suggested References

Additional information on contract surety bonds is available from:

### Surety Information Office



[www.sio.org](http://www.sio.org)

- *The Importance of Surety Bonds in Construction*
- *10 Things You Need to Know About Surety Bonding*
- *Why Do Contractors Fail?*
- *Alternative Financial Security: A Bad Deal for Owners*
- *Surety Bonds Versus Bank Letters of Credit*
- *Protect Your Construction Lending Capital with a Surety Bond*
- *Surety Bonds at Work*

By the time the surety becomes involved in a claims investigation, both the contractor and the owner generally are disenchanted with each other. Positions are either polarized, or headed in that direction, and each party has its own opinion of the circumstances surrounding the dispute! This is the environment in which the surety claims representative must make decisions.

Accordingly, one key to the prompt and orderly conduct of *A Construction Project Owner's Guide to Surety Bond Claims* is to provide adequate documentation and assistance to the surety claim representative as quickly as possible. A surety cannot definitively respond to a claim until it has investigated the facts associated with the alleged default of the contractor.

*If there is no owner default, the surety's obligation under this bond shall arise after...The owner has declared a contractor default and formally terminated the contractor's right to complete the contract.*<sup>3</sup>

This standard provision establishes a very important condition precedent in order for the surety to respond to claims presented under the performance bond. The surety's obligations mature after the contractor has, in fact, defaulted and been declared by the owner to be in default. In the event of a voluntary default, the contractor will inform the owner and the surety that it can no longer perform its obligations under the contract and will ask the surety to respond to the owner.

It's important to keep in mind that:

1. The surety is not a judge or referee of disputes between the owner and the contractor. Until such time as the contractor has been properly declared in default of the contract, the surety's obligations to the owner have not matured.
2. If the contractor is, and is declared by the owner to be, in default under the contract, the surety will take action.
3. There are three basic forms of default:
  - a) default via a breach of a material contractual term or condition related to the work such as failure to make satisfactory progress;
  - b) financial default such as failure to pay suppliers or subcontractors for work properly performed; and
  - c) voluntary default.

## **PAYMENT BOND CLAIM**

But what if the surety had discovered an entirely different problem in which its contractor was not responsible for the delays? Here's yet another scenario:

### **Suggested References**

Additional information on contract surety bonds is available from:



#### **National Association of Surety Bond Producers**

[www.nasbp.org](http://www.nasbp.org)

- *Bonds on Public Works*
- *Guidelines for*

*Evaluating*

*Contract Bond Forms and Contract Documents*

- *The Basic Bond Book*



#### **Surety Association of America**

[www.surety.org](http://www.surety.org)

- *Glossary of Fidelity & Surety*
- *Bond Authenticity Program Obligees' Guide* with user information, instruction, model inquiry form, and list of surety companies

*Through its investigation, the surety learned that you, the owner, had issued 28 change orders to the contract. These change orders had included the extension of the completion time by 45 calendar days, and Quality Constructors had a schedule prepared indicating that the revised completion date could be met, with only one major exception. E-Z Mechanical, the subcontractor that had filed the notice for non-payment, ordered the wrong equipment for installation, was behind schedule, and would undoubtedly be required to work overtime to achieve the revised completion date. Under the terms of the subcontract, Quality Constructors had the right to withhold funds due to the failure of E-Z Mechanical to perform. The surety concludes, therefore, that its principal, Quality Constructors, is not in default under the contract and notifies the owner.*

*After learning this from the surety, you get a phone call from your attorney, whom you contacted as soon as you heard E-Z Mechanical wanted to place a lien on the project.*

*“You are not going to believe this, but I was just at the courthouse and learned that E-Z Mechanical filed for Chapter 11 Bankruptcy. They missed last week’s payroll, and their vendors are lining up to file claims. I expect that we will have liens filed against us by the end of today. Did you hear anything from the bonding company?”*

*“Yes, the bonding company said they had received our notice of claim, but that their preliminary investigation found that Quality is not in default of the contract.”*

*But, what about the 25 E-Z Mechanical workers who had their paychecks bounce last Friday and the six vendors and a representative from the Department of Revenue who are all looking to you for financial recovery?*

Since this claim involves a failure to make payments to subcontractors, you look to the payment bond provided by Quality Constructors for some answers.

*With respect to claimants, this obligation shall be null and void if the contractor promptly makes payment, directly or indirectly, for all sums due. The surety shall have no obligation to claimants under this bond until...[a notice of claim is made]<sup>4</sup>*

In our example, it’s E-Z Mechanical who is now insolvent, but the bond in hand is from Quality Constructors. Have you bonded the wrong contractor? The answer is no. The bonds provided by Quality Constructors will protect your project from unpaid bills and liens because of the subcontractor’s default. You know that you have paid Quality Constructors every month, on time. There is no question you’ve held up your end of the agreement!

What else does the payment bond say?

*Claimant: An individual or entity having a direct contact with the contractor or with a subcontractor of the contractor to furnish labor, materials, or equipment for use in the performance of the contract...<sup>5</sup>*

This definition presents an interesting twist. As an owner of the project you are named as the obligee on the payment bond, however you do not fit the definition of a claimant! How do you make a claim on this payment bond? The answer is that in most circumstances you do not need to because the claimants



**Suggested References**  
Additional information on contract documents is available from:

**American Institute of Architects**  
[www.aiaonline.com](http://www.aiaonline.com)

**Associated General Contractors**  
[www.agc.org](http://www.agc.org)

**General Services Administration**  
[www.gsa.gov/forms/forms.html](http://www.gsa.gov/forms/forms.html)

can pursue payment directly from the contractor and surety. In fact, the payment bond will explicitly provide that the claimant has a direct right of action against the surety.

Since the first order of business was to protect the integrity of the project from liens or encumbrances, you are pleased to learn that the persons who worked for E-Z Mechanical, and who are threatening to file a lien against the property, can take their claim to Quality Constructors and its surety for satisfaction under Quality's payment bond.

But, of all these people and companies, how will the surety know who has a valid claim? Once again, the importance of a thorough claims investigation becomes clear. The contractor and surety have the responsibility to conduct this investigation and to validate the claims. Remember, their commitment to you is to assure you that the project will be completed and delivered free of liens or other encumbrances as provided for in the contract. Your responsibility is to be certain that the claimants who come forward are appropriately directed to the contractor and the surety to investigate and pay valid claims. All the calls from potential claimants can be directed to Quality Constructors and/or All American Surety, who have been advised of the situation and are prepared to work with you to resolve these claims.

*For the moment your problem is solved. E-Z Mechanical's workers and suppliers will be paid, and at least they are off your back.*

*But then you learn that All-American Surety is trying to reach you. They want to discuss the results of their investigation, and have some requests to make of you regarding the referral of claimants to their office.*

*All-American has been working hard over the weekend. Because of your claim notice they met with Quality Constructors and learned of the dispute between Quality and E-Z Mechanical. They also learned that E-Z Mechanical was bonded to Quality Constructors by Old Faithful Insurance. There was a performance bond and a payment bond in place, and one of the events of default under the subcontract agreement was failure to pay for labor or material. Another was declaration of bankruptcy or insolvency. All American had already contacted Old Faithful, and Old Faithful was expecting calls from the claimants.*

Confused? Here's what has happened.

1. When you obtained a performance bond and a payment bond in support of your contract, you received the irrevocable commitment of the surety that the contractor will complete the project, and pay for labor and material, or, in the event of a default on the part of the contractor, the surety will perform under the bonds. As part of the guarantee, the surety agreed that it would be responsible for conducting the process of validating the claimants' rights to payment.

***Special thanks to  
James Pateidl,  
Executive Vice Presi-  
dent, Lockton Insur-  
ance Agency, Kansas  
City, MO for his  
contributions to this  
publication.***

The claims investigation now becomes a valuable service to you! Because Quality Constructors and its surety have the responsibility of payment, it only makes sense that they will conduct the validation process. To be successful in the investigation they must have the claimants referred to them, removing the claimants from your responsibility. You now have “partners” in the form of a contractor and surety who are investigating the claims.

2. During the investigation, the surety has learned that there were other contractual agreements that bear on the outcome of the problems with your project. The fact that the contractor had required his or her subcontractors to provide a bond was a very important piece of information.

In this scenario, you referred the unpaid workers and suppliers of E-Z Mechanical to your contractor, Quality, and its surety, All-American. Since it has been established that E-Z Mechanical had provided subcontract bonds to Quality, however, Quality and its surety will, in turn, refer these claimants to E-Z’s surety, Old Faithful.

Under the payment bond from E-Z Mechanical, and because E-Z Mechanical was clearly in default of its subcontract, Old Faithful Insurance has an ultimate responsibility to Quality Constructors regarding the actions they must take to resolve the claim and mitigate their loss.

There are two very important practices in the surety industry:

1. A surety will respond to claimants, under either a performance bond or a payment bond, and begin an investigation as a result of receiving a notice of a claim.
2. With a performance bond or payment bond, the surety must be satisfied that its contractor owes a debt before it will pay it.

## CONCLUSION

While the scenarios presented in *A Construction Project Owner’s Guide to Surety Bond Claims* are quite simplified, they are not meant to oversimplify the surety claims process, which can be quite complex, or even to suggest that the resolutions to the problems represent what you should expect when you are faced with a claim. Rather, they are presented to explain how and why the process works as it does.

Keep in mind that the entire matter of surety claims is predicated on the legal interpretation of a contractual relationship, as developed through our legal system, including statutes and legal precedents.

When there is a proper default, the surety has the obligation to respond to the owner and perform in accordance with the terms of the contract, subject to the limitations and understandings contained in the performance bond. In

## References

<sup>1</sup>The Miller Act of 1935 is a federal law mandating surety bonds on federal public works projects. The Miller Act requires performance and payment bonds for all public work contracts in excess of \$100,000. Also, each of the 50 states, District of Columbia, Puerto Rico, and almost all local jurisdictions have enacted legislation requiring surety bonds on public works (generally referred to as “Little Miller Acts”).

<sup>2</sup> AIA A312 Performance Bond, December 1984 edition

<sup>3</sup> AIA A312 Performance Bond, December 1984 edition

<sup>4</sup> AIA A312 Performance Bond, December 1984 edition

<sup>5</sup> AIA A312 Performance Bond, December 1984 edition

<sup>6</sup> For further information, contact the Surety Association of America (SAA) at 202-463-0600 or the National Association of Surety Bond Producers (NASBP) at 202-686-3700.

addition to this obligation of the surety, the proper declaration of default allows the surety to exercise its option to proceed in discharging its bond liability, if any, without risking a claim by the contractor for interference with the contract.

These are easy statements to make, and generally describe the principles that are involved in a surety claim. However, anyone familiar with commerce and our legal system can appreciate the fact that there are exceptions to every rule.

What should you do?

**First, be fair in your contract and in dealings with the contractor.**

When entering a contract, you do so for the end goal of completing the project to fulfill a defined need. If you require your contractor to bond the project, you are taking the extra step and expense to use a prequalified contractor to perform the work. What remains is to manage the construction process and to comply with your part of the contract.

**Second, be prudent in managing the construction process.**

Name one body of law that has more case law than that surrounding the construction industry. It is hard to do!

**Third, know and understand the traditions of the construction industry and your contract, including your responsibilities under it.**

**Fourth, document the progress of your project.**

Remember that the surety promises to fulfill the contract when the “principal is in default of the contract and has been declared to be in default by the obligee.” Well-documented project files go a long way towards assisting the claims representative in his or her investigation, and ultimately help you substantiate the default if the matter goes to court.

**Fifth, seek legal assistance in pursuing your claim.**

If you are involved in a surety claim, something has gone wrong in the contractual relationship between you and your contractor. Given the multitude of jurisdictions, and the thousands of interpretations surrounding the case law governing the construction industry, you should not rely on a layperson’s interpretation of a contract, nor should you rely on a surety to make those interpretations for you. Seek legal counsel to assist you with this contractual problem, and in doing so, seek counsel who is familiar with the construction industry. This is a specialized field of law. Proper counsel can save time, money, frustration, and frequently, unnecessary litigation.

Finally, we have emphasized that the claims investigation is required once a default or complaint is made. Find out who is in charge of the surety claims operations from the contractor or surety bond producer, and be certain to follow instructions for proper notification, in writing, to that party.<sup>6</sup> Getting the process underway correctly is vital to prompt and effective claims service.

*For more information about contract surety bonds contact:*



**Surety Information Office**  
5225 Wisconsin Ave., NW #600  
Washington, DC 20015-2014  
(202) 686-7463  
Fax: (202) 686-3656  
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*The information source on contract surety bonds. SIO is supported by SAA and NASBP.*



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