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Strategies for Reaching an Early Resolution with the Performance Bond Surety of a Defaulting Subcontractor

A very common complaint within the construction industry is the perceived lack of responsiveness of performance bond sureties in connection with requests to timely cure or voluntarily pays for the consequences of subcontractor default. Sureties are perceived to be litigious and non-responsive. The value of a performance bond as security against a subcontractor default is, in turn, perceived to be of somewhat questionable value, particularly with the advent of alternative industry products, most notably Subguard.

There is little doubt that at least a few sureties have earned this negative reputation, and many of us have personal experiences that reinforces the industry perception. And yet, the performance bond product remains an ingrained facet of our industry.

For instance, certain owners are unwilling to approve or pay for Subguard, effectively mandating the use of performance bonds on those projects. Occasionally, certain subcontractors will not qualify for enrollment in Subguard, but may be able to provide a performance bond. In addition, alternative performance security products, including Subguard, are expensive. The true cost of Subguard year-to-year has the potential to become much higher than the performance bond alternative when policy deductibles are considered. For these reasons, and despite the advent of Subguard several years ago, there can be little doubt that performance bonds will remain an aspect of virtually every contractor's risk management strategy for the foreseeable future.

The inevitability of the industry's continued utilization of performance bonds as security against subcontractor default prompts a more pointed evaluation of any contractor's own internal management of subcontractor default in the performance bond context, in particular:

(1) the contractor's management of its own obligations under the performance bond, and
(2) the contractor's understanding (or lack thereof) of the performance bond surety's obligations to the defaulted subcontractor.

Both of these inter-related issues influence the contractor's success or failure in timely and efficiently obtaining the benefits available under a performance bond.

In fact, several industry commentators suggest that it is the general contractor's own failure to understand and comply with its performance bond obligations which leads to many disputes between sureties and general contractors (referred to under the bond as "obligees"), rather than any general culture of bad faith within the surety industry:

> *Claimants and their counsel frequently demonstrate a basic lack of knowledge of both (a) the rights and obligations of obligees and payment bond claimants versus sureties on the one hand, and (b) the rights and obligations of sureties towards bond claimants and their principals and indemnitors* [i.e. subcontractors] *on the other hand. This lack of knowledge often leads to a needless waste of time, misunderstandings, acrimony, and critical and irretrievable missteps, which can imperil claims or place claimants and sureties needlessly*

> *at odds. What often could and should be a smooth, seamless process becomes needlessly hostile, causing obligees, payment bond claimants, and sureties unnecessary delay and expense in resolution of claims.*

Tomey, Daniel E. and Tamara McNulty, *Surety Bonds: A Basic User's Guide for Payment Bond Claimants and Obligees*, 22 Constr. Lawyer 5 (2002).

While it is not the purpose of this article to discuss all facets of surety law, it is important for contractors to take away a few key strategies for dealing with sureties, which are derived by viewing the contractor's bond obligations from the perspective of the surety.

Perhaps the key difference between a performance bond and Subguard is the fact that a surety, unlike the Subguard insurer, owes binding legal and contractual obligations to both parties to a subcontractor default – (a) the general contractor (the "obligee") and (2) the defaulted subcontractor (the "indemnitor").

Although differing bond forms clarify the specific duties of a surety, generally speaking a surety owes an obligation to the general contractor to:

(a) investigate the default in good faith, and
(b) perform the subcontractor's obligations in the event that a default is confirmed.

By contrast, the surety owes the defaulted subcontractor an obligation to:

(a) investigate the default in good faith, and
(b) not pay any amounts or incur any costs that do not arise from a valid and properly imposed subcontract default.

The potential for conflict in these obligations is clear, and the surety's exposure in the event it is found to have violated its obligations to the subcontractor is real. Unlike the Subguard insurer, who has no obligation to the subcontractor and an absolute right to seek recovery (subject only to the subcontractor's ability to pay), the performance bond surety must investigate the default declaration and determine that the subcontractor has no legal or contractual defense before it pays the general contractor. In nearly every instance, the defaulted subcontractor, who must indemnify the surety, will contend strongly that it does have valid defenses and that the general contractor is the party in default or in the wrong.

If the surety pays the general contractor over the objection of its subcontractor/indemnitor, and the subcontractor is later able to demonstrate that the surety did so prematurely, without adequate investigation, or under circumstances in which a default was not adequately established, then the surety will not be allowed to recover from the subcontractor and its principals under its indemnity agreement. The Subguard insurer prices its premiums and sets deductibles in order to offset its relatively high risk of non-recovery. The surety, on the other hand, sets its premiums in reliance on obtaining recovery in a majority of cases based on the security interests it takes in the subcontractor's and its principals' business and personal assets.

Accordingly, it is in a contractor's best interests to help the surety meet its obligations to its defaulted subcontractor so that, in turn, it is easier for the surety to meet its obligations to the contractor with confidence that it can obtain a recovery from the subcontractor and maintain the benefit of its bargain. This

will increase the surety's ability to move quickly and to pay the full amount due to the contractor under the bond with a minimum of disputes and delays.

How do we do this? The following are suggested steps to follow when dealing with a defaulting subcontractor's performance bond surety. These recommendations are designed to satisfy not only a contractor's obligations but are also designed with an eye toward satisfying the surety's expectations as well.

Strategy 1: READ THE BOND, BOTH WHEN THE SUBCONTRACT IS PUT IN PLACE AND WHEN THERE IS ANY POTENTIAL OF DEFAULT OR BREACH, AND THEN DO WHAT THE BOND REQUIRES

Although this initial step appears obvious, what is actually required here is more complicated than it may appear at first blush. For instance, who should read the bond? The answer is everyone involved in managing the subcontractor. In all likelihood, this is multiple individuals: the on site subcontracts manager; the project manager; any company contractor administrator; and perhaps even more senior management and counsel in certain circumstances. Performance bonds are contracts, and they are not all created equally. While most of subcontractors utilize a contractor's standard form subcontract, which the contractor's management personnel are familiar with, there is not a "standard form" performance bond. Instead, most sureties have their own bond form and these forms differ, sometimes significantly, with respect to the conditions they place on the surety's obligation to perform.

For instance, some bond forms require that the surety be informed in advance regarding every change order issued to the subcontractor. Others require that the surety be copied on default notifications to the subcontractor. Still others require that the subcontractor actually be terminated before the surety has any obligation to the contractor. If a contractor fails to follow the conditions of the bond, then performance by the surety will be delayed and may even be excused. In addition, even on a single project, different subcontractors may provide performance bonds with differing conditions.

When should the bond be read? The answer is both at the time the subcontract is negotiated and put in place, and again when a default *may have* occurred. As noted, some bonds include conditions that arise prior to a default, such as notice of change orders. It is important that those with responsibility for managing the subcontractor are aware of any "pre-default" requirements. Next, nearly every bond form imposes specific requirements on the general contractor in the event of a default by the subcontractor. Typically, the consequence of failing to meet any "time of default" bond conditions will excuse the surety from any obligation to perform, at least until the condition has been satisfied.

Typical "time of default" conditions include: (i) timely notification of the surety, (ii) the requirement to provide documentation of the default, and (iii) assistance in the surety's investigation. Certain bond forms afford the surety specific and lengthy periods of time within which to perform an investigation. Frequently, a subcontractor default involves a deterioration in performance over an extended period of time before the contractor actually formally declares the default. Often, it is only at some point after a formal declaration of default, and sometimes only after counsel has been hired, that the subcontractor's surety is brought into the fold. As noted below in Step 2, this late involvement of the surety is a mistake, and is likely to unavoidably impact the contractor's ability to require the surety to perform in a timeframe that will be acceptable to either the contractor or its clients. In the meantime, the contractor may be forced to incur significant costs to

supplement the subcontractor in order to mitigate the impact of the subcontractor default on the overall project while the surety "investigates".

Finally, the contractor must comply with the terms of the bond, whatever they may be. The negotiation of the terms of subcontractor bonds is beyond the scope of this article; however, whatever the agreed terms are, the contractor's personnel must ensure that it complies with its obligations under performance bonds, and does so in a timely fashion, whether or not the contractor fully agrees with the conditions the surety may have imposed. Performance bonds are, in all material respects, contracts, the terms of which must be followed, as with any other contract to which a contractor is a party. For instance, certain bonds require that the subcontractor be terminated in order for the surety's obligation to arise. While it may your judgment at the time of the default that the appropriate course of action is to supplement the subcontractor, rather than terminate for default, doing so may excuse the surety from any responsibility.

If, after reading a performance bond, there is any question regarding the obligations the contractor must meet to preserve or trigger its rights under the performance bond, counsel should be contacted.

Strategy 2: ENGAGE THE SURETY EARLY, EVEN WHEN THE DEFAULT IS POTENTIAL OR IMMINENT

One of the most common yet understandable mistakes made when dealing with a performance bond surety is the failure to notify the surety and engage them in the subcontractor default until after the default has begun to impact the project. In many cases, the surety is not notified until after the subcontractor has been given multiple opportunities to cure its performance. The hesitation to "up the ante" prematurely is natural given the importance of preserving good personal and professional relationships with subcontractors. The cost of failing to involve the surety as soon as you become concerned that a default is a real possibility, however, can be steep.

One of the key consequences of failing to involve the surety early is delay in obtaining action from the surety when the default has finally occurred. Subcontractor defaults often lead to a ripple effect, impacting downstream work, the overall project schedule, the contractor's costs and, ultimately, the contractor's relationship with the owner/client. The reasons for effecting the most immediate default cure possible are self-evident.

As previously noted, one of the surety's key rights, whether expressly stated in the bond or not, is to conduct an investigation of the default. This, of course, takes time. In the interim, it is difficult to obtain any performance from the surety. If the subcontractor default has already occurred and is already impacting the project when the surety is initially notified, it is unlikely that the surety will be in a position to take action within a timeframe that will be acceptable to you as contractor. As a result, the contractor may be required to expend its own funds to effect a cure, defeating the purpose of the bond. In addition, the longer the contractor delays in engaging the surety, the longer the necessary investigation will take. Also, to the extent a contractor effects its own cure without the consent of the surety, this may create defenses that the surety can later assert to avoid paying the bill when the contractor presents it.

There are benefits to engaging the surety early, aside from the avoidance of delay or the cost and risk associated with a contractor effecting its own cure. First and foremost, is the opportunity for the surety to take proactive and early steps to prop up the subcontractor before a more serious default occurs. Typically

the surety has a much greater understanding of the subcontractor's "big picture" – its financial obligations, other contracts, assets and liabilities – than the contractor ever will. If the surety is involved early, it may be willing to take proactive steps to limit its own exposure to a broader subcontractor default. To borrow a phrase – "the surety doesn't know what it doesn't know". Frequently, the surety and the contractor's interests are aligned in avoiding or mitigating the default. Once a default has occurred, however, the surety and the contractor's interests are more adverse, particularly if the surety is concerned that it may not be able to fully recover the costs the contractor seeks under the performance bond from the defaulted subcontractor.

Next, as previously noted, when a default occurs, it is common for the subcontractor to assert that the general contractor is the party in default, not the subcontractor. As ridiculous as this may sound to a contractor after having dealt with a difficult subcontractor during the course of the project, this allegation is one that the surety must take very seriously if it expects to recover any of the amounts it ultimately expends in connection with the default. Involving the surety early allows the contractor an opportunity to clearly demonstrate its compliance with the contract and gives the surety an opportunity to observe its subcontractor's non-performance, taking away one of the most significant impediments to surety action – concern that the default may not be valid based on information the surety may not *yet* have discovered through investigation. If the surety is involved throughout the period during which the default is occurring, the surety representative's personal observations will eliminate these doubts.

Finally, early engagement allows contractor personnel an opportunity to build credibility with the surety representatives. It helps to establish commitment to minimize cost and resolve problems without unnecessary adversity. In the event that the subcontractor default results in significant losses, this credibility will be of critical importance in minimizing the transaction costs the contractor must incur in obtaining payment from the surety, who may be poised to incur a substantial loss as a function of paying the contractor's claims. The converse is also true. If the contractor fails to notify the surety only after the subcontractor has faltered for months, mitigation opportunities have come and gone, and everyone involved in the project is under maximum pressure to act, the surety will naturally be frustrated by its late engagement and the perception of lost mitigation opportunities. As a result, the surety will be inclined to attempt to turn its late engagement into a defense and may also perceive that the contractor's late notice has somehow prejudiced its position. The result will be a more adversarial and drawn out resolution process.

Strategy 3: MAKE THE DEFAULT OBJECTIVE AND VERIFIABLE

Another common mistake which leads to delay in obtaining performance by the surety is the declaration of a "subjective" default by the contractor. It is critical for the contractor to take every reasonable step to convert "subjective" defaults into "objective" and verifiable defaults, which the surety can easily appreciate and the subcontractor cannot easily dispute.

What does this mean? Common complaints regarding subcontractor performance include, by way of example:

- "Subcontractor X doesn't have enough manpower and is not likely to finish on time."

- "Subcontractor X hasn't been paying his subcontractors; we have been issuing joint checks, but we hear they are going to file bankruptcy."

At first blush, these complaints may appear to be relatively straightforward and justifiable reasons for declaring a default. When considered more closely, however, these "defaults" are problematic for a general contractor if it expects the surety to take immediate action.
In the case of the first example – not "enough" manpower; and "not likely to finish on time" – without the benefit of undisputed objective data, the subcontractor can easily dispute these statements. They are subjective evaluations. For instance, how much manpower is "enough"? If the contractor terminates the subcontractor, it will contend that it would have brought in XX (fill in the blank) number of workers the very next day (or "as many as necessary") and that the contractor's termination was wrongful. If the contractor defaults the subcontractor because it is not "likely" to finish on time, the subcontractor will contend that issues beyond its control are delaying it and therefore it is not responsible for the delay.

While the contractor may be confident that it can prove these arguments to be false, the surety may not be so sure. At a minimum, the surety will likely take the position that the competing positions of the subcontractor and the contractor need to be evaluated via expensive analyses and time-consuming investigation before any action will be taken. Meanwhile, the contractor will be in the position of either (i) having to fund any remedial effort and await the surety's decision or (ii) expend resources pushing the surety to act and refuting the subcontractor's position, (iii) or both. This result is potentially avoidable if proactive steps are taken to make the default more objective, verifiable and less subject to dispute.

For instance, if prior to the default declaration we first request the subcontractor to provide a manloaded schedule (or utilize a prior-submitted manloaded schedule) to establish agreed manpower levels, then we at least have a measureable and agreed baseline against which the subcontractor's actual manpower can be measured. In the case of delay, if the contractor first meets with the subcontractor to develop an agreed completion schedule which both parties sign, and closely document the performance of the subcontractor (and any potential delays) against the agreed completion schedule for a period of time, then it has created an objective and agreed basis to declare a default if the subcontractor does not comply with the schedule. The bottom line is that proactive steps taken early by the contractor to make a subcontractor's default subject to objective verification prior to the formal declaration of default (and perhaps even with the involvement of the surety) will make it much easier to access the resources of the surety.

In the second example, mentioned above, the subcontractor's failure to pay its own subcontractors and suppliers is, in and of itself, an objective, "black and white" default. Under this scenario, however, the contractor has undertaken a process of issuing joint checks. While this may be an expedient temporary solution, it also effectively cures the subcontractor's "black and white" default. Perhaps you should have declared the default first. Now you fear that the subcontractor may declare bankruptcy. This "fear" is a subjective basis for default. There is no way to truly confirm whether this concern is real unless and until the subcontractor actually declares bankruptcy or, perhaps, completely abandons the project. In addition, if the subcontractor declares bankruptcy, those laws include special protections which may complicate the contractor's ability to obtain a timely remedy or terminate the subcontractor post-bankruptcy. In addition, any efforts made to help "finance" a troubled subcontractor may later translate into defenses for the surety if you make financial agreements without the consent of the surety.

The better approach would have been to engage the surety when you first became aware of the subcontractor's non-payment. You ultimately may agree with the surety and the subcontractor that you will

issue joint checks, but perhaps in exchange for that agreement, you can have the subcontractor and surety acknowledge a default in writing, which would make it much easier for both the surety and the contractor to access the bond in the future should the subcontractor's financial position deteriorate.

These are simply examples, and I recognize that each default or potential default will have its own unique set of facts. Simply put, however, at the first sign of a potential subcontractor default, the project team needs to develop a strategy for objectively establishing the default, presuming it will ultimately materialize. In addition, once a preliminary strategy has been developed to document an objective default, or whenever an objective default has occurred, the contractor needs to engage the performance bond surety in the resolution. It is also advisable to engage counsel to assist the project team in the development of effective strategies to document the default and engage the surety.

Strategy 4: ISOLATE COSTS, AND DOCUMENT, DOCUMENT, DOCUMENT!

A final recommendation for streamlining dealings with a performance bond surety is to be sure to promptly isolate and track all of the costs that you attribute to the subcontractor default. Estimates, costs that cannot be audited, and costs which are not clearly tied to the default will be difficult to recover.

A separate but related consideration is the need to carefully document all of the pertinent information in connection with the default. In particular, all key communications with the subcontractor or the surety need to either be made or be confirmed in writing. Unfortunately, the resolution of subcontractor defaults and bond claims can take months or, in some cases, years. It is critical therefore to document what is occurring in real time before memories fade or those involved become unavailable.

In addition, it is important to keep pressure on the surety to take the action that you is believe necessary and required under the bond. Your ability to demonstrate entitlement persuasively and in writing, with a clear audit trail of costs and demonstrable compliance with obligations under the subcontract and the bond is indispensible to achieving the quickest resolution possible. If you are not able to demonstrate in writing to the surety that you have met the conditions of the bond, that an objectively verifiable default has occurred, and at the same time demonstrate the financial and other consequences of that default, then the surety will be much more likely to delay taking action, either because of a concern that the obligations it owes the subcontractor have not yet been satisfied or, alternatively, the hope that a defense to the contractor's claim may still exist. As a practical matter, it is the contractor's burden to demonstrate this to the surety before it can reasonably expect the surety to take action. Accordingly, documentation, including the isolation of all default-related costs, is critical.