

**TWELFTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

**CONTRACTOR DEFAULT INSURANCE v. SURETY BONDS
ARE TRADITIONAL CONTRACT BONDS OBSOLETE?**

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_____As owners and general contractors try to find ways to manage risk of default or non-performance, the promise of a risk management tool that is faster, cheaper, and better sounds tempting. If an owner or general contractor is considering default insurance, its benefits and shortcomings should be explained. This paper will examine the relative strengths and weaknesses of contractor default insurance versus bonds in protecting an owner or general contractor from the consequences of default in the construction context, and offer some practical observations about this new type of insurance and its viability in today's bond market.¹

Surety Bonds

Contract surety bonds are effective tools for shifting the risk of contractor or subcontractor failure to a surety company. A surety bond is a three-part agreement under which one party (the surety) guarantees to another party (the obligee) that a third-party (the principal) will perform a construction contract. The obligee is the entity or individual who is the beneficiary of the bond. When a prime contractor is required to provide a surety bond, the obligee is generally the owner of the construction project, and the prime contractor the principal. When a subcontractor is required to provide a surety bond, the obligee is generally the prime contractor of the construction project, and the subcontractor the principal.

Surety bonding is a careful, rigorous, and professional process in which the surety scrutinizes the reputation, ability, and capital of the prospective principal to ensure that it is capable of performing the project.² When surety companies underwrite a principal, they are providing the obligee with assurance that the principal will perform in accordance with the terms and conditions of the contract. Sureties recognize that the substantial expenses incurred in the underwriting process are necessary to avoid subsequent costs and potential losses.

Both owners and general contractors manage risk and attempt to prevent losses by requiring surety bonds. In both situations, subcontractors are protected from others' default and are assured payment from the surety. Additionally, the term of coverage cannot be canceled by a party, and provides protection against claims until the time expires as stated in the contract, or under applicable law.

A **Performance Bond** states that the principal will perform its contract in accordance with the contract documents. A performance bond may be required of a contractor by an owner or a subcontractor by a general contractor. The performance bond protects the owner or general contractor from financial risk should the principal default on its obligation to perform

¹ The following information was primarily derived from pamphlets entitled, "It's All About Risk," and "Are You Protected?," published by The Surety Information Office (SIO), 5225 Wisconsin Avenue NW, Suite 600, Washington, DC 20015-2014, and located on SIO's website: sio@sio.org.

² Lynn M. Schubert, et al., *Contractor Default Insurance and Directed Suretyship, The Law of Suretyship* 539 (Second Edition, American Bar Association 2000).

the job in accordance with the terms and conditions of the contract. It covers 100% of the construction contract.

A **Payment Bond** guarantees that those individuals supplying labor or materials on a construction project will be paid subject to any restrictions and limitations imposed by statute, the contract, the subcontract, or the bond. A payment bond gives certain subcontractors, laborers, and suppliers the right to make a direct claim against the surety. Additionally, a payment bond usually carries no additional cost when purchased with a performance bond. It covers 100% of the construction contract.

An established history of case law exists concerning surety bond forms, and their interpretation and validity. The terms and conditions of the bonds are also well defined in statutes, regulations, and case law, and priorities well-established in bankruptcy law. With regard to government projects, federal³ and state statutes require bonds on public works projects over a minimal size; few government agencies have the staff, expertise, and underwriting skills possessed by surety companies. Moreover, taxpayer dollars are protected by surety bonds and keep politics out of the contractor prequalification process. The U.S. Treasury department maintains a list of surety bond companies it has qualified to write surety bonds for federal projects. For state and local projects, surety companies are regulated by state insurance departments, which conduct periodic examinations of surety companies and enforce all insurance laws that pertain to surety bond companies.

Default Insurance

Default insurance was developed in the last few years by certain large brokers and insurers in an attempt to offer an insurance product that could compete with surety bonds by providing indemnity for damages caused by contractor and subcontractor default and non-performance.⁴ Default insurance is marketed as a cost effective alternative to traditional performance and payment bonds, with simplified claims handling.

While default insurance is marketed as a cheaper alternative to bonds, default insurance actually provides minimal protection to owners and general contractors against principal default and offers no protection to subcontractors, laborers, or suppliers. In fact, remaining subcontractors, laborers, or suppliers have no right to file a claim directly with the insurer. A typical default insurance policy is only a two-party agreement between the insured (the owner or general contractor) and the insurance company. The policy only indemnifies the insured for “qualified loss”, which is usually defined as the costs and expenses above a certain minimum amount the owner or general contractor must pay as a result of the principal’s default (applying deductible and co-payments). Certain exclusions to claims also exist in the policies.

Default insurance can also discourage fair competition. Many general contractors and subcontractors have developed long-term relationships with their sureties and surety bond agents. General contractors and subcontractors also have the opportunity to deal with more

³ The Miller Act, 40 U.S.C. § 270a, *et seq.*

⁴ SCHUBERT, *supra* note 2, at 540.

than one surety company. If denied a bond by one company, they can apply to another. With default insurance, contractors have no choice of companies and must forgo the protections of a surety bond. This limitation on competition can eventually result in higher costs and increased risk of default.

The term of coverage under default insurance also appears to provide less protection than that of bonds. Under default insurance, the insurer has the right to cancel the policy for certain reasons. The policy itself may also contain certain restrictions on the length or scope of coverage.

Unlike surety bonds, so few default insurance policies have been sold that claims case studies, legal precedents, or claims histories are not established. Also, terms and conditions of the default insurance policies have not been defined outside of the policies. Default insurance is untested in the public works arena as well. Default insurance is not required by state or federal governments; in fact, federal and state statutes require surety bonds on public works projects over a minimal size. Thus, the evolving nature and limited use of the product implies a lack of the stability that is found with performance and payment bonds.

PREQUALIFICATION

Surety Bonds

One of the most valuable services of a surety bond is prequalification of bidders - either contractors or subcontractors. Prequalification is an impartial, thorough process where the surety analyzes:

1. Financial strength and credit history of the bidder;
2. The bidder's experience and reputation;
3. The bidder's exposure and progress on other contracts;
4. The contract documents;
5. The size and location of the work; and
6. The bidder's ability to perform that work.

Moreover, an established relationship between a contractor or subcontractor and a surety can help a contractor or subcontractor grow. Pre-qualified, bondable contractors or subcontractors are able to work on public projects, are qualified for a certain type and level of work, and are able to benefit from the expertise of the surety and its agent.

Default Insurance

There is no third-party prequalification performed with default insurance. The contractor default insurer shifts the qualification obligation to the insured through policy provisions "warranting" certain standards and through deductibles, co-payments, and sublimits of insurance.⁵ The owner or general contractor (or the insurer if the default insurance proposed to prequalify bidders) is solely responsible for predetermining the capability and capacity of the

⁵ SCHUBERT, *supra* note 2, at 541.

bidders to complete the contract. Pre-qualifying all bidders is not only expensive, but it is also difficult for an owner or prime contractor to effectively prequalify them without access to the detailed confidential financial data, personnel information, and business plans that the bidder's surety has at its disposal; an insured does not have the time or resources to duplicate a surety's underwriting. Moreover, prequalification by just one entity (the owner, prime contractor or insurer) can increase the price and the length of the project.

Without third-party prequalification, qualified contractors or subcontractors may also be faced with unfair competition. If an owner allows a single insurer to decide who can bid, it can all but eliminate competition, and even invite favoritism and corruption. By contrast, if a surety mistakenly rejects a qualified bidder, the bidder can choose from several other sureties to secure its bond. If every bidder must be accepted by a single insurer, there is no alternative.⁶

Qualified contractors or subcontractors may also face undue competition from unqualified contractors or subcontractors. Since the performance of all contractors or subcontractors may be covered under the default insurance contract, without consideration of prequalification, the owner or general contractor could lose its incentive to consider a contractor's or subcontractor's ability to perform the contract. The owner or general contractor may focus only on the lowest price rather than qualifications, sacrificing quality and risking a potentially greater chance of default.

Proponents of default insurance argue that owners and prime contractors can include more startup and minority contractors and subcontractors on a project by using default insurance. This is probably because of the lack of prequalification. However, only contractors and subcontractors without the capability and finances to perform the work are unable to obtain surety bonds. Moreover, the surety industry has numerous programs to ensure that such contractors can obtain bids. In the present strong bond market with a variety of sureties actively seeking small contractors, any qualified contractor can obtain a bond with the assistance of a competent bond agent or broker.⁷

Prequalification is particularly significant in a public works project. Under most public works laws, public owners must award the contract to the lowest responsible bidder. No additional prequalification is allowed. That is why prequalification by a surety is so valuable; it allows a public owner to be certain that all bidders submitting bids with the required surety bonds are deemed qualified to perform the contract by an independent third party.

CLAIMS HANDLING ISSUES

Surety Bonds

If a contractor or subcontractor defaults and is covered by a bond, the surety assures the obligee that the contract can be completed and that the subcontractors, laborers, and suppliers will be paid. When contractor or subcontractor default occurs, the surety offers

⁶ Id. at 542.

⁷ Id. at 543.

support to the owner or contractor who may not wish or be prepared to deal with the situation. The owner or contractor does not have to deal with unpaid creditors, suppliers, and laborers and does not have to administer the contract to completion. The surety may bring in a replacement contractor or subcontractor to complete the work, finance the present contractor or subcontractor to completion, or negotiate a financial settlement with the owner or general contractor and issue payment.

If a contractor or subcontractor defaults on a project, the remaining subcontractors, laborers and suppliers are protected. Not only does the surety ensure continuation of the project, but the remaining subcontractors, laborers and suppliers are guaranteed payment as provided by law and under the payment bond, and may file a claim for payment directly with the surety.

Default Insurance

With default insurance, if a contractor or subcontractor defaults on a project, owners or contractors must first reassign the work, subject to applicable laws on advertising and bidding, pay for completion of the work, pay losses, and then submit a notice of loss to the insurer. If it is deemed a “qualified loss”, the insurer indemnifies the owner or contractor for the loss up to the established limit, minus deductibles and co-payments. The owner’s cash flow can be negatively affected by this arrangement, which could have negative effects on the project. Conversely, a performance bond pays from the first dollar of loss and guarantees performance of the contract with no limits or sublimits other than the penal sum of the bond which is 100% of the contract price.⁸

Also, although an insured owner may recoup monetary damages, he or she would receive no other assistance from the insurer on the project; default insurance does not obligate the insurer to complete the work, pay a defaulting contractor’s bills, or obtain another contractor. The insurer’s involvement is triggered only upon default, whereas a surety can assist a troubled contractor before actual default occurs in order to mitigate the loss. It is also significant that surety claims handlers are ordinarily more experienced and knowledgeable than insurance claims adjusters with regard to default or non-performance issues in the construction context.

____ Additionally, default insurance policies do not cover claims of the remaining subcontractors, laborers and suppliers. In fact, the remaining subcontractors, laborers and suppliers have no right to make a claim under the insurance policy and are left exposed. The adverse impact from unpaid claims can have a significantly detrimental effect on these entities, especially startup and minority contractors and subcontractors. Conversely, an unpaid subcontractor or supplier can make a claim directly with the surety.⁹ Default insurance also exposes the owner or prime contractor to the possibility of liens on the project. Since the remaining subcontractors, laborers and suppliers cannot file a claim directly, they may file a lien on the project in order to obtain payment.

⁸Id. at 542.

⁹ Id. at 542.

COST

Surety Bonds

Surety bond rates vary depending upon the type of construction, the surety company, and the experience and financial strength of the contractor or subcontractor. Premiums tend to range from one to three percent of the contract price, and may be as low as one-half percent or less on very large projects. Bonds may also lower the cost of construction by facilitating the use of competitive bids by qualified contractors and subcontractors. Moreover, a payment bond usually carries no additional cost when purchased with a performance bond.

Default Insurance

A default insurer anticipates losses, and charges a sufficient premium to pay for them while still earning a reasonable profit.¹⁰ The insurer uses the premiums to pay for losses instead of to prevent defaults.¹¹ Additionally, default insurance is subject to deductibles, and co-payment requirements and only provides indemnity after the contractor has failed and the owner has paid its losses.¹² Although part of the premium for a default insurance policy may be refunded if there are no losses or very low losses, losses below a certain pre-established amount are not considered “qualified losses” and are not counted toward the deductible. Moreover, because of the promise of a refund, owners and contractors may be reluctant to file claims and thereby raise their premiums. Thus, the prospect of a lower premium than a surety bond may not materialize after a true comparison of the cost of each and their value and services.

BONDS AND WRAP-UP INSURANCE

By themselves, performance and payment bonds offer owners and general contractors the protection they need to assure fair competition of qualified contractors and subcontractors, as well as performance and payment guarantees in the event of default. If an owner or contractor purchases default insurance *in addition* to general contractor or subcontractor performance and payment bonds, rather than in place of them, the remaining subcontractors, laborers and suppliers should have payment protection. However, some owners’ or contractors’ insurance/bond agreements may dilute the protections provided by surety bonds. These “combining agreements” usually stipulate that a payment bond claim may be made under the default insurance policy or under the bond, but not both. Also, only the insured (the project owner or contractor) may make the claim. A principal contractor or subcontractor, or the remaining subcontractors, laborers and suppliers, may not make a direct claim and do not play an active role in the claims process.

¹⁰ The initial premium is commensurate to bonds. Id. at 545.

¹¹ Id. at 542.

¹² Id. at 545.

At least one default insurer has offered to provide both default insurance and bonds in response to state and federal statutes requiring bonds on public works projects. However, there is no indication that this hybrid complies with applicable laws; no legal precedents have been established to test its validity on application. Moreover, since the default insurance policy provides less than 100% coverage, and the bonds are required by statute, there is no clear benefit to using the combination bond/insurance hybrid, and costs would naturally be increased.

CONCLUSION

While the purported benefits of default insurance may cause some owners and general contractors to give serious consideration to purchasing it rather than traditional surety bonds, a closer examination reveals that bonds offer the best value and the best and most efficient methods to prevent losses, to assure performance, and to protect against financial harm, while default insurance forces the owner to forgo important financial protections afforded by bonds. The limited utilization of default insurance in construction projects to date demonstrates that this conclusion is apparent to owners and contractors as well.