ALTERNATIVES TO TRADITIONAL BONDING

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Alternatives to Traditional Bonding

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I. Introduction
The purpose of bonds are to provide financial security under a variety of arrangements. There are, however, other vehicles used to provide similar financial security. Moreover there have been some recent innovative development in surety products to try to address one of the perceived shortcomings of a traditional bond, that being the time between notice of default and the resolution of the default and the commencement of some sort of cure (tender, takeover, financing, etc.) This paper will also examine a few of the main project types for encountering alternatives to traditional bonding.

II. Bonding P3 Projects
Under traditional public procurement laws, public entities are not typically allowed to operate on credit. That is, public entities must have funding arranged for and set aside to cover each financial obligation that they enter into. Public entities have traditionally not been able to finance projects like most private projects are financed, that being getting a bank loan secured by a lien on the real property. In the recent past, a move has been underway to try to open up some alternate sources of funding public projects beside the “money in the bank” traditional method. Along came the Public Private Partnership (“P3”) which permits the teaming between a public entity and a private entity to construct public facilities using non-traditional financing alternatives. Toll roads are a good example of such an arrangement. Rather than having a governmental entity have to save up the significant funds needed to construct a road, a private entity could help fund and then collect the revenue from the tolls and use it to finance the debt service on the road construction with a share going to the public entity. Public Private Partnerships are most often encountered in road construction given the significant financial investment these projects take. Because of the significant financial size of these projects and the associated costs with bonding such projects, there has been use of other financial security measures for these projects as authorized by statute. Below
you will find a multi-state survey of the schemes employed by various states on P3 projects.

ALABAMA

- Ala. Code 23-1-80 thru 95
- Alabama permits P3s in the context of roadway projects.
- Excerpt: “Section 23-1-92. Advertisement for contract bids - Requirement. … the lowest reasonable and responsible bidder for such work, who shall enter into bond in double the amount of such bid, conditioned for the proper performance of such contract according to the plans and specifications and within the time prescribed by the order of the county commission of such work, which bond shall be approved by the judge of probate of said county.”

FLORIDA

- Florida law authorizes counties, municipalities, school boards, and other governmental entities to enter into P3s for the construction of structures that serve a public purpose. Fla. Stat. § 287.05712.
- As an example: FLA. Stat 334.30 provides authority to use the P3 on transportation projects. A comprehensive agreement establishing the P3 project must provide for the delivery of performance and payment bonds, letters of credit, parent company guarantees, or other security acceptable to the public contracting entity in the form and amount satisfactory to the public contracting entity.
- 334.30 (c) “The department shall balance the structure of the security package for the public-private partnership that ensures performance and payment of subcontractors with the cost of the security to ensure the most efficient pricing.”
- There are other statutes of Florida permitting P3s in other contexts.

GEORGIA

- Georgia’s P3s are permissible on Department of Transportation projects. Georgia’s statutory language is silent on P3 bonding requirements. Ga. Code Ann. § 13-10-1.2, § 13-10-40 thru 65.

LOUISIANA

- Louisiana permits P3s for transportation, parishes and municipalities.
- “The comprehensive agreement shall provide for: Delivery of performance and payment bonds or other forms of completion guarantee in connection with the construction of or improvements to the qualifying transportation facility, in the forms and in amounts satisfactory to the authority.” See La. Rev. State Ann 48:2084.1-.15

TENNESSEE

- Permits tolling as an additional and alternative funding source.
- No specific language related to performance guarantees.

**TEXAS (Other than Road Projects)**

- Bonds required by statute on a P3 project are the same as normal governmental project bonds in Texas Chapter 2253 of the Texas Government Code. See Texas Government Code 2267.0605. In addition the private partner must put up a letter of credit.

  “Sec. 2267.0605. PERFORMANCE AND PAYMENT BONDS REQUIRED. (a) The construction, remodel, or repair of a qualifying project may be performed only after performance and payment bonds for the construction, remodel, or repair have been executed in compliance with Chapter 2253 regardless of whether the qualifying project is on public or private property or is publicly or privately owned.”

  (b) For purposes of this section, a qualifying project is considered a public work under Chapter 2253 and the responsible governmental entity shall assume the obligations and duties of a governmental entity under that chapter. The obligee under a performance bond under this section may be a public entity, a private person, or an entity consisting of both a public entity and a private person

  Sec. 2267.058. COMPREHENSIVE AGREEMENT. (a) Before developing or operating the qualifying project, the contracting person must enter into a comprehensive agreement with a responsible governmental entity. The comprehensive agreement shall provide for: (1) delivery of letters of credit or other security in connection with the development or operation of the qualifying project, in the forms and amounts satisfactory to the responsible governmental entity, and delivery of performance and payment bonds in compliance with Chapter 2253 for all construction activities; 2267.061(d) The responsible governmental entity may make any appropriate claim under the letters of credit or other security or the performance and payment bonds required by Section 2267.058(a)(1).

For a more comprehensive discussion see “Public-Private Partnership Laws in the States, Including Surety Bond Requirements.” November 1, 2013. Available at [www.NASBP.org](http://www.NASBP.org) and [www.surety.org](http://www.surety.org).

**III. Texas Road Projects**

The traditional requirement on a public project in Texas is to have a payment and performance bond in 100% of the contract amount. See, e.g., TEX. GOV’T CODE § 2251.021(c)(2). This is generally the standard for public projects as well as non-road P3 projects. But road projects in Texas are sometimes treated differently. Given the
massive costs of some of these projects, bonding can be difficult to come by. There is also, perhaps, an intention to try to save some of the premium costs associated with bonding such a large project. In 2005, Texas introduced a statutory alternative to traditional bonding on certain road projects, providing:

PERFORMANCE AND PAYMENT SECURITY.

(a) Notwithstanding Section 223.006 and the requirements of Subchapter B, Chapter 2253, Government Code, the department [Texas Department of Transportation] shall require a private entity entering into a comprehensive development agreement under this subchapter to provide a performance and payment bond or an alternative form of security in an amount sufficient to:

(1) ensure the proper performance of the agreement; and

(2) protect:

(A) the department; and

(B) payment bond beneficiaries who have a direct contractual relationship with the private entity or a subcontractor of the private entity to supply labor or material.

(b) A performance and payment bond or alternative form of security shall be in an amount equal to the cost of constructing or maintaining the project.

(c) If the department determines that it is impracticable for a private entity to provide security in the amount described by Subsection (b), the department shall set the amount of the bonds or the alternative forms of security.

(d) A payment or performance bond or alternative form of security is not required for the portion of an agreement that includes only design or planning services, the performance of preliminary studies, or the acquisition of real property.

(e) The amount of the payment security must not be less than the amount of the performance security.

(f) In addition to or instead of a performance and payment bond, the department may require one or more of the following alternative forms of security:

(1) a cashier's check drawn on a financial entity specified by the department;

(2) a United States bond or note;

(3) an irrevocable bank letter of credit; or
(4) any other form of security determined suitable by the department.

(g) The department by rule shall prescribe requirements for an alternative form of security provided under this section.

TEX. TRANSP. CODE § 223.205.

A notable difference in this statute is that it only requires financial security for that portion of the project that relates to construction. It expressly states that it does not have to cover the design, preliminary studies, or the acquisition of real property. It is also worth noting that the public entity can require a combination of payment and performance bonds and one of the other forms of financial security. Among the above alternatives, the most common financial security instrument in the authors’ experience thus far has been the letter of credit (discussed in more detail below).

When compared to traditional bond or lien projects in Texas, the above letter of credit projects arguably leave open several legal issues for the letter of credit claimants, as well as those who defend against such claims. For example, to what extent, if any, does a letter of credit claimant need to prove its labor and/or materials were actually delivered to and/or incorporated into the road project? This can be an important concept when one considers just how massive these road projects are, literally stretching for miles, and how high the letter of credit claims can be (in the authors’ experience, sometimes $250,000 to $500,000 per claimant). Regarding the contents of the notice letters sent by the letter of credit claimant, is strict compliance or substantive compliance required? Some of these claimants may not fulfill all of the technical requirements of the notice, which may (or may not) make the difference in whether the claimant is paid hundreds of thousands of dollars.

Another critical, potentially unresolved, issue: are these claimants entitled to recover at least some of their attorney’s fees related to their claims? What about the parties who defend against invalid claims? Are they potentially entitled to their attorney’s fees? Clearly lien claimants and traditional statutory payment bond claimants – and the parties who successfully defend against such claims – have at least a chance to recover some of their attorney’s fees under Texas law (for comparison, see Texas Property Code Section 53.156, regarding lien claim attorney’s fees, and Texas Government Code Sections 2253.073-74, regarding bond claim attorney’s fees). But the right to recover attorney’s fees is not as clear under the recent Texas law allowing letters of credit or other forms of security.

These issues will hopefully be clarified soon, especially considering some of the benefits of using a letter of credit; those benefits are discussed in more detail immediately below.

IV. Letters of Credit

One financial security instrument that is used in many contexts is the letter of credit. Letters of credit are commonly used in securing international transactions involving the sales of goods. The irrevocable letter of credit (“ILOC”) or standby letter of credit is a
contractual agreement between a financial institution (a bank) and the party to which the letter is issued. It requires the bank to pay up to a set amount, against drafts meeting the terms of the letter of credit. In the letter of credit it will contain instructions on how to draw down on the letter of credit. For example, it may require an invoice and proof of delivery in order to enable the party to collect the money for the invoice. It may require an affidavit attesting that a claim is owed. The bank does not analyze claims and raise the defenses of the person who has obtained the letter of credit (generally an account holder at the bank). Rather, it pays when someone meets the documentary or other requirements set forth in the letter of credit.

Letters of credit and surety bonds are obviously different. There are certain aspects of letters of credit that make them more favorable to use than bonds and some aspects that make them less favorable. For a claimant looking to be paid they are better because the bank will not investigate the default, rely on the defenses of the “principal.” The claimant must simply meet the terms of the letter of credit and it should pay. (i.e. provide an affidavit that the “principal” is in default and has been terminated.) If a project owner has already lined up its own completion contractor the project can continue with very little down time.

Surety bonds, on the other hand, provide alternate forms of value that a letter of credit does not. The bonding process involves underwriting. If a contractor has been bonded, they have been through some sort of underwriting process that, in theory, helps validate the contractor. Letters of credit are typically 100% collateralized. This typically results in a situation where letters of credit are not provided for the full project value. With a set of payment and performance bonds, in theory, the bonds provide double the project value in coverage (100% project value for the performance bond, 100% project value for the payment bond). With a letter of credit, you get money. With a bond, you probably get someone to assist in the completion of the project, locating a substitute contractor, analyzes the claims of unpaid subcontractors, etc.

Letters of credit undoubtedly are the favorite for providing quick access to capital to finish a project. Bonds are superior in providing prequalification of contractors and assistance in completing a project. They are different tools for different sets of priorities.

V. Subguard

Subguard Insurance, also known as “Subcontractor Default Insurance,” is a lesser-known alternative to the established requirement of surety bonds. Subguard Insurance is a two-party agreement, as opposed to the three-party agreement for surety bonds, between a general contractor and an insurance company in which the insurance company assumes the risk of a defaulting Subcontractor. As with any form of insurance, there are both benefits and drawbacks to Subguard Insurance.

The biggest benefit to a Subguard Insurance policy is that it covers all subcontractors on a particular project. When a default occurs, the general contractor (insured) has only one option—to take over the project. The general contractor is then required to inform the insurer of the default and state how it intends to solve the issue.
This grants the general contractor an extensive amount of leeway to keep the project moving forward. With surety bonds, the surety is in control and has multiple options (e.g., take over the project, obtain another contractor to take over the project, provide the principal with the finances necessary to take over the project, or simply pay the applicable penalty).

There are also drawbacks to Subguard Insurance. First, Subguard Insurance does not satisfy the statutory requirement for providing a payment bond. Second, Subguard Insurance requires deductibles to be met before coverage kicks in, whereas coverage begins immediately after the first payment with surety bonds. Third, the procedure for making coverage payments for Subguard Insurance may also be seen as a disadvantage to some general contractors. With Subguard Insurance, the general contractor (insured) will pay for the default and then collect from the Subguard insurer. Thus, the general contractor is the first person the owner will look to after a subcontractor defaults. With surety bonding, the surety pays for the default and then collects from the principal (or in another manner consistent with the terms of the indemnity agreement). This gives the general contractor more of a buffer in the event of a default. Finally, with Subguard Insurance, all claims must be made during the term of the policy. In other words, Subguard Insurance does not provide coverage for any defective work that was discovered after the policy has expired. Surety bonds, on the other hand, provide protection so long as the statute of limitations for the applicable legal claim has not expired. This allows for a longer period of protection.

VI. Parental Guarantees

Parental guarantees are another source of financial security used when there are related entities such as a parent company and subsidiaries. The parent company or a related entity guarantees the performance of the subsidiary or related entity. A parental guaranty is not much different than a bond, except that the guaranty is coming from a related entity and not from an unrelated company that charges a premium for its service.

Parental guarantees are used when there is concern over the financial stability of a subsidiary and/or there are concerns that the subsidiary is thinly capitalized, asset poor, or is a single purpose entity and the enterprise would simply allow a judgment be taken against the subsidiary rather than putting forth the financial resources to cure a default, pay damages, etc. Parental guarantees are common in the industrial/oil and gas/manufacturing space where projects and risks can reach significant sizes. Parental guarantees are also common in dealing with local subsidiaries of foreign corporations.

VII. Headstart Performance Bond™ (a Guarantee Company of North America product)

General Contractors have expressed a need for improved responsiveness and flexibility from the Surety industry. Project delay is a significant risk for a General Contractor and costly delay damages due to the default of a subcontractor can quickly make a project unprofitable. Given this, General Contractors don’t want to wait for a Surety to complete its investigation of a Performance Bond claim, which can be a lengthy process. This has led General Contractors to gravitate towards more “on-
demand” products like Subguard Insurance. It is also recognized that General Contractors are well-equipped to quickly and efficiently find a replacement subcontractor. For example, they typically take steps well in advance of noting a subcontractor in default to line up a possible replacement contractor.

The Guarantee responded to the demand by General Contractors for a more responsive product by creating the Headstart Performance Bond™, which is available in the Canadian marketplace. The Headstart Performance Bond™ is similar to the standard Canadian Construction Documents Committee (CCDC) 221-2002 Performance Bond, (which is comparable to the AIA A312 Performance Bond) except it allows for a rapid response under a “Headstart Option”. The Headstart Performance Bond™ also has the added precondition that the Obligee has taken the work under the Contract out of the hands of the Principal when they make a claim. The intention is for the Surety’s response to be triggered much further along in the default process, rather than when a default is simply declared. By the time the Obligee makes a claim under the Headstart Performance Bond™, they are in a position where a replacement contractor is needed immediately.

Under the Headstart Option, the Obligee submits a detailed completion proposal with a replacement contractor to the Surety along with their notice of claim letter. For transparency and to streamline the process, the Bond includes links to a standard form mitigation agreement which is acceptable to the Surety and a templated notice of claim letter. The Surety commits to respond to this proposal within 3 business days. Typically, there is no timeline for the Surety’s response expressed in the Performance Bond. This provides General Contractors assurance that they will receive a clear, actionable response from the Surety in short order.

If the Surety accepts the Obligee’s completion proposal, then they proceed to enter into a mitigation agreement with the Obligee. The parties proceed under a reservation of rights allowing the Surety to continue to conduct their investigation even after the completion proposal is accepted and the job has restarted. The Obligee’s replacement contractor begins the completion of the remaining work immediately, and the Surety makes shortfall payments as necessary. If the Surety rejects the Obligee’s completion proposal, then the process reverts to that of the standard CCDC Performance Bond with the Surety in control of the completion option.

The Headstart Performance Bond™ has been gaining traction in the Canadian construction industry since its introduction in 2014. Recently, the Ministry of Transportation of Ontario (MTO) has stated a preference for the Headstart Performance Bond™ on projects where bonding is required. The Surety Association of Canada has also endorsed the Headstart Performance Bond™ as a form of bond.

VIII. Conclusion

In summary, there are a number of standard ways and even more creative ways to provide financial security on a construction project. While typical performance and payment bonds are a standard go by, the surety professional must understand that
there are other products available that compete with a surety’s standard offerings. From a customer service/sales standpoint it is important to understand the competition and listen to what the market's complaints are about bonding and attempt to address them as the Guarantee has done with their Headstart Performance Bond™. Of course the laws of suretyship and the practicalities of establishing liabilities, verifying damages and defenses limit what can be done. From a claims and subrogation standpoint, it is important to understand what else is out there and how these products operate when looking around for possible avenues of subrogation.