



# Surety Bonds: Two Perspectives – Broker and Attorney

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## The Basics

Most government construction contracts, and many larger private developers, require the contractor to obtain performance and payment bonds.

Federal construction projects with values in excess of \$100,000 require surety bonds under the Miller Act. At the state level, the "Little Miller Acts"<sup>1</sup> require surety bonds based on various project value thresholds.<sup>2</sup>

Under New York's Wicks Law, when the State or its agencies bid for building construction work, they are required to contract directly with individual trades.<sup>3</sup> Thus, trade contractors need surety bonds.

Performance bonds protect the project owner. Performance bonds guarantee that if the contractor cannot complete the contract, either because of lack of financing or because of poor workmanship, that the surety company issuing the bonds will complete the project without the owner having to expend more than originally planned.

Payment bonds protect subcontractors and sub-subcontractors. The payment bond guarantees that if a subcontractor or a sub-subcontractor is not paid, that the surety will pay the debt.

Contractors pay the premiums (1-3% of the contract price) for performance and payment bonds with the bonding fees included in their bids.

## What Your Surety Broker Wants You to Know – Obtaining Bonding Capacity

What contractors can be certain of is their ability to obtain a surety bond will affect their ability to participate in numerous construction projects. It is essential, therefore, that construction business owners understand what is involved in the process, and how to work with a team of professionals to meet the criteria surety companies set for obtaining a bond.

Obtaining a surety bond, and establishing bonding capacity, is much like going to the bank for a loan. It's based on a company's and its indemnitors' credit capacity and history. Vital to the process is the involvement of a certified public accountant (CPA) experienced in construction and capable of meeting the surety's requirements for financial statements. The financial statement must be prepared using accepted accounting and auditing standards, and must be based on the balance sheets, income statements, accounts payable and receivable, expenses, work in progress schedules, and other financial conditions. Make sure the financial information prepared by the CPA is consistent with the contractor's other financial documentation, and that a thorough check and balance is performed to ensure a consistent and accurate financial picture.

The surety bond producer will then step in to secure the bond, supported with additional important documentation such as the construction business executives' biographies, business plan, methods of operation, and risk management plan, and market/competitive position.

Other documentation often requested by surety companies includes:

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- A business continuity plan,
- Succession plan,
- Key man life insurance policy on the principals naming the construction company as the beneficiary,
- Bank lines of credit documentation to ensure a remedy for potential cash flow problems, and
- Third-party references (i.e., owners for whom the contractor successfully completed projects, subcontractors and design professionals.

Following these guidelines, contractors can effectively obtain the right surety bond and begin establishing a relationship with surety companies based on professionalism, thorough documentation, and performance.

### What Your Attorney Wants You to Know – Understanding the Risks

Now that you have obtained a bond, the next thing is to understand the risks. The most important thing your attorney wants you to know about performance and payment bonds is the power of the indemnity agreement.

The contractor, its corporate officers, and usually the corporate officer's spouses, must sign an indemnity agreement. Those who sign the indemnity agreement are called "indemnitors." The indemnity agreement is a promise by the indemnitors to reimburse the surety for any payment the surety has to make on the contractor's behalf. Surety bonds, therefore, are not insurance.

The indemnity agreement gives the surety broad power and discretion. The typical indemnity language states that the surety may settle any claim against the bond as long as the surety makes the payment in "good faith ... under a belief the surety is liable for such claim," or such settlement was "necessary or expedient." As one court noted: "[T]he 'good faith' clause in the indemnity agreement precludes litigation over questions of whether the [contractor was] 'actually liable for the

payments claimed . . . or actually defaulted on [its] contracts."<sup>4</sup> While the discretion given to sureties is broad, it is not unlimited when the contractor can show that the surety did not act reasonably<sup>5</sup>, failed to act with "diligence"<sup>6</sup>, or "blindly paid on bonds without investigating or defending claims"<sup>7</sup>.

The best practice is to try and avoid problems in the first place. If a contractor senses trouble, two things are recommended. First recommendation: Document, document, document. To the extent possible, document the scope of work completed, and document that the work was correctly installed. Contractors should take pictures, give owners timely notice of progress so owners can inspect the work, and promptly order any testing required to demonstrate the work is sufficient. If you are prevented from performing your contract because of others, document as best you can the source of the interference. Second recommendation: Get your surety involved, and work with your surety. The surety does not want to be taken advantage of by an unscrupulous owner, or an unscrupulous payment bond claimant. Show the surety that you are compliant with the contract and, to the extent possible, that the other party is not compliant.

<sup>1</sup> 40 U.S.C. § 3131.

<sup>2</sup> New York State Finance Law § 137 (requiring payment bonds); New York does not have a single statute covering performance bond requirements.

<sup>3</sup> New York General Municipal Law § 101 (Wicks Law).

<sup>4</sup> First Natl Ins. Co. of Am. v. Joseph R. Wunderlich, Inc., 144 Fed. Appx. 125 (2nd Cir. 2005).

<sup>5</sup> Hartford Fire Ins. Co., Inc. v. Edgewater Constr. Co., Inc., 21 A.D.3d 1312 (4th Dept. 2005).

<sup>6</sup> Federal Ins. Co. v. Walker, 53 N.Y.2d 24, 35 (1981).

<sup>7</sup> St. Paul Fire & Marine Ins. Co. v. Pepsico, Inc., 160 F.R.D. 464 (SDNY 1995).

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