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The Rumble in the Jungle

Letters of Credit, Bonding and Default Insurance: Hedging Bets in a Roller-Coaster Market

By Jonathan J. Dunn and John J. Petro

"The Rumble in the Jungle…"

The favored method of developing and delivering completed construction projects in the United States has long been the design-bid-build method.[1] Under this "traditional" method generally, the owner separately engages a design professional to furnish detailed plans and specifications for the purpose of securing hard bids from contractors,[2] then separately contracts for the work. One of the primary legal doctrines of the "design-bid-build" delivery system is known as the *Spearin* doctrine,[3] which provides "the contractor will not be responsible for the consequences of defects in the plans and specifications …"[4]

On the other hand, absent an agreement to the contrary, a basic tenet of design profession law is that the designer's obligation to the owner is not held to perfection, but rather to the standard of care in the industry for designers on similarly situated projects in the location.[5] As a result, "it is not uncommon for the contractor to insist that the root of the problem is a design error, while the designer insists that the problem is caused by a construction deficiency."[6]

Perhaps in response and with other perceived benefits, some owners have been turning with increasing frequency to alternative project delivery methods. The purpose of this paper and the workshop is to explore methods of securing performance risk in these "non-traditional" project delivery methods. In particular, this paper discusses surety bonds, letters of credit, parent guarantees and insurance options for securing performance risk on alternative delivery projects in today's marketplace.

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Contextual Background

Today's (Volatile) Marketplace

In December 2007, the United States economy began an economic downturn that has been dubbed "The Great Recession."[7] During this recession, the construction industry was particularly impacted. According to data from the United States Bureau of Labor Statistics, the Construction Industry lost more jobs than any other; estimated at 1.8 million.[8] Thus, the impact of poor economic conditions – although they vary widely depending on industry sectors and geographic locations – are perhaps greater than ever, such that contractors and their advisors are particularly sensitive and vulnerable at this time to the risk of contractual performance defaults when undertaking construction contracting.

For instance, according to FMI Corporation's Special Report, 2011 Surety Providers Survey,[9] FMI commented as follows on the Construction Market Outlook:

> What difference does a year make? Not much for nonresidential construction. While there were signs of growth at the beginning of 2011, that optimism has once again been tempered by reality. The FMI Nonresidential Construction Index (NRCI) dropped in the third quarter … U.S. government construction projects are slowing, while private projects show only small signs of picking up. … Federal and state budgets are in a constant state of emergency and uncertainty, and the electioneering is starting again, so we can be certain the uncertainty will continue.

In the surety survey section, FMI summarized the responses from surety underwriters as follows:

> When probed as to their clients' ability to succeed in this market environment, respondents indicated a high level of uncertainty as to possible outcomes. A full 90 percent said that their contractor clients were "tentatively positioned" with "some exposure" to stable or growing markets …

The comments of underwriters who regularly study financial statements and

balance sheets of their clients are telling, and like the recent spikes and dips in the 2011 Dow Jones Industrial average, the only certainty seems to be the uncertainty of these financial times.

Risks Inherent in Construction

At the risk of extreme understatement, there are numerous risks inherent in construction. For instance, there are planning and selection risks, contract formation risks, site risks, permit and regulatory risks, resource risks (including labor, materials and equipment), design risks, coordination and management risks, environmental risks, financial risks, risks of time, payment, injury and property damage, and all of these risks are relatively commonplace to greater and lesser degrees in all construction projects.[10] Some risks involved in construction can be insured, including – typically – accidents that cause injury and property damage, subject to various policy exclusions, of course.[11] Other risks, however, are typically assigned to parties contractually.[12]

Risk of Contractual Non-Performance

The focus of this paper is the risk of contractual non-performance, or contract performance *assurance*. For this risk, there are nearly always contractual,[13] legal,[14] statutory,[15] and equitable remedies, but these remedies may or may not have actual value.[16] Further, to determine the value of these remedies would require an "underwriting" analysis of financial aspects of each project and each contracting party, which may be difficult or impossible to efficiently or effectively perform. As an example, sureties routinely assess these risks. Obtaining surety credit involves an underwriting analysis, under which sureties require contractors to execute and deliver an agreement of indemnity and sometimes post collateral.[17] The economic climate that presently exists and has existed for the past several years has brought about more stringent underwriting, such that sureties often also require officers and shareholders and their spouses to agree to be personally obligated to indemnify the surety, and standard indemnity agreements give sureties broad rights and remedies.[18]

But the indemnity agreement is merely a starting place. Surety underwriters also analyze the "three C's:" Character, Capital and Capacity.[19] Character means just what is says, i.e., does the bond principal have the character and reputation as trustworthy and not consistently in controversies and litigation? Capacity refers to: 1) the general know-how to perform the proposed contract and the management and supervisory personnel to do so; 2) the availability of the tools and equipment necessary to perform the contract; and 3) the past experience in similar contracts, locations, and conditions. Capital is the surety's analysis of the principal's financial condition, which includes an analysis of work-on-hand, working capital, retained earnings, loans, and balance sheet and earnings history.[20] Yet even with all this analysis, sureties still paid out losses in excess of $685 million in 2008.[21]

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Unlike sureties, project owners and others may not have access to a contractee's financial information, performance history, and other "underwriting" information, or the option of insisting on personal indemnity from officers and shareholders. Even if they gained access, though, project participants may find it significantly more efficient and reliable to depend on sureties, banks, or insurers to assist them in hedging against the risk of contractual non-performance and in particular, insolvency risks. The main sources of this contractual non-performance risk protection in the construction industry has been surety bonds, letters of credit, guarantees, and relatively recently, subcontractor default insurance.

Construction Industry Contractual Performance Risk Protection - The Basics

Bonds, letters of credit, guarantees, and subcontractor default insurance each have their own peculiarities, legal implications and risks purchasers should consider in the context of their risk tolerances and project fit. The following sections describe the general nature of these different forms of performance risk protection.

Surety Bonds

History of Suretyship

Suretyship is one of the oldest forms of obligations. There are references to suretyship in the temple of Apollo at Delphi in Ancient Greece[22] and it is the subject of Proverbs in the Bible.[23] In medieval times, sureties were often relatives that were taken hostage until the task was performed. In his book, "The Common Law (1881)," Oliver Wendell Holmes, Jr., wrote:

It is popularly supposed that the oldest forms of contract known to our law are covenant and debt, and they are of early date, no doubt. But there are other contracts still in use which … at least suggest the question whether they were not of equally early appearance. … [¶]

It may, perhaps, sound paradoxical to mention the contract of suretyship. … [T]he surety of ancient law was the hostage, and the giving of hostages was by no means confined to international dealings.

Perhaps it was this harsh treatment of sureties that resulted in legal and equitable defenses and remedies that sureties were given as long ago as 1215 in the Magna Carta.[24] Since then a specific body of law has developed for suretyship,[25] which includes surety rights, defenses and remedies that are not often found in the bond language itself.

When American law of suretyship developed, those who served as surety for others were likely not in the insurance or surety business. Rather, they were accommodation parties serving, typically without compensation, as surety for the benefit of a relative, friend or neighbor whose credit was such that business could not be conducted without a surety providing a guarantee of that person's performance.[26] Typically, in this setting, the surety's undertaking was set forth in the terms of a document not drawn by the surety but likely drawn by the obligee for whose benefit the undertaking was provided. Thus, courts in the older cases involving sureties tended to state that the surety is a "favorite of the law" and the contract of suretyship was *strictissimi juris*.

One should not, however, reach the conclusion from the multitude of the subsequent case law embracing the theory that a surety is a favorite of the law and its contract *strictissimi juris* that all jurisdictions were in accord. In fact, in both New York and Illinois, early cases made it clear that, where a surety (commercial entity or not) authored the surety contract, the surety was not a "favorite of the law," and an ambiguity in the language of the surety authored undertaking would not be construed in favor of the surety.[27] Moreover, as to the theory of *strictissimi juris*, the New York Court of Appeals in *Richardson v. Steuben County*[28] clearly articulated the approach of many courts in interpreting the obligation of a surety as follows:

The rule that the liability of a surety is to be strictly construed is so often reiterated with a very general sense of its true meaning that we perhaps may profitably recall just what its application is to such a case as this. It does not mean that in interpreting the undertaking of a surety we are to be governed by different fundamental rules than those which are applicable to the construction of another contract. And least of all does it permit us to cast aside the principle applicable to all contracts that in their interpretation we are to seek for the true intent of the parties who executed them. *After that intent has been discovered and the meaning of the contract determined, it is of course true that the liability of a surety is to be strictly and rigidly limited by the scope and meaning of the instrument which he has executed*. (Emphasis added)

By 1885, one of the first companies in the commercial surety business, the American Surety Company, began underwriting construction contract performance bonds.[29] Since then, suretyship has become a large and often profitable (and at times a significantly unprofitable) segment of the business of commercial insurance companies. The fact that suretyship has become a commercial enterprise has changed the attitudes of virtually every court. Illustrative of this attitude change is the following quotation from a decision of the Supreme Court of Indiana:

...the rule of *strictissimi juris*, which has been invoked for the benefit of private individual sureties who sign for accommodation, and not for com-pensation, and which requires a strict construction of the contract in their favor, and a resolution of all doubts in their favor, does not apply to the involved contract of a surety company which becomes a surety for profit. In the latter case the rule is reversed and the contract, when there is room for construction, is to be construed most strongly against the surety and in favor of the indemnity which the obligee had reasonable ground to expect.[30]

Thus, while at one time sureties were considered favorites of the law whose contracts were *strictissimi juris*, such is no longer the case, at least with respect to commercial enterprises who charge a premium or fee to undertake to guarantee the performance of another.

Surety Defined

In the "Restatement of the Law, Suretyship and Guarantee," the authors define a surety as follows:

> (1) This Restatement applies (i.e. one is a surety)...and a secondary obligor has suretyship status whenever: (a) pursuant to contract (the 'secondary obligation') an obligee has recourse against a person (the 'secondary obligor') or that person's property with respect to the obligation (the 'underlying obligation') of another person (the 'principal obligor') to that obligee; and (b) to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other obligation; and (c) as between the principal obligor and the secondary obligor, it is the principal obligor who ought to perform the underlying obligation or bear the cost of performance.[31]

Said in another way, a surety is one who contracts to answer for the debt or default of another and is primarily liable to the obligee for the debt.[32] As between the obligee, on the one hand, and the principal obligor and the surety on the other hand, the obligation of the principal and the surety to the obligee is joint, several and primary.[33] However, as between the principal and the surety, the principal is primarily liable for its debt or default, and the surety is secondarily liable.[34]

Surety Is Not Insurance

Insurance and suretyship should not be confused. An insurance policy provides indemnity to its customer (the insured) against loss arising from a fortuitous but statistically predictable event. It is a contract between two parties, the insurer and the insured. Essentially, the insurer agrees that, in the event the insured sustains a loss as the result of an event (a covered occurrence – typically an accident), then the insurer will provide indemnity within the limits of coverage to the insured for the loss sustained. The purchase price of the policy, the premium, is controlled by the state department of insurance and is calculated based on the statistical certainty of loss. The premium charge for a policy of insurance takes into account that statistical certainty of loss, spreading the cost of such losses among the entirety of the group of insureds.[35]

A surety bond is a contract between three parties, the principal, the obligee and the surety. The surety's promise to the obligee is not one of indemnity, but instead is a promise to provide substituted performance or to pay money, limited in amount to the penal sum of the bond, in the event of the failure of the principal to perform. The premium paid for the bond is not calculated based on the possibility of the occurrence of an event (a default) which might result in a loss. Instead, it is based on the extension of financial credit from the surety to the principal.[36] Thus, after considering the "three C's," today's surety underwriter, if satisfied that the proposed principal is a good candidate for surety credit, will often apply a multiple to the calculated working capital and net worth and derive a work program for the principal that will take into account a single job limit as well as a total annual bonded work program. From that point forward, assuming that the other underwriting criteria are met (i.e., indemnity, collateral, and/or stable financial results) the surety will execute bonds on a contract by contract basis based on the principal's request if it fits within the approved work program.[37]

In a contract of insurance, if there is an occurrence causing a loss to which the policy applies, the insurer owes a duty of indemnity to its insured. In a surety bond, if there is a default, the surety owes a duty of substituted performance or payment to the obligee, but the surety is entitled to indemnity from its principal. The principal owes a duty to the surety to indemnify and hold harmless the surety from any loss or liability which the surety may incur as the result of the execution of the bond. This duty of indemnity was created at common law on the basis that any default for which the surety must answer is, in the first instance, the obligation of the principal. In modern practice, sureties do not rely solely on the common law right of indemnity when executing a bond. Instead, concurrent with the execution of a line of bonding credit or concurrent with the execution of a bond, the surety will require its principal, and often third-parties such as the corporate management of the principal, to sign an agreement of indemnity that gives the surety broad rights and remedies.

There are references to suretyship in the temple of Apollo at Delphi in Ancient Greece and it is the subject of Proverbs in the Bible.

There are two typical construction industry bonds used: performance bonds and payment bonds; and one premium is charged for both bonds.[38] The premium is based on the construction contract amount, so bonds are usually for 100% of that amount. Very generally, performance bonds cover future performance of the bonded contract,[39] while payment bonds cover non-payment of the principal to lower tier suppliers of labor, materials and covered services.[40]

Special Considerations: Performance Bond Forms

The most popular form of performance risk protection is performance and payment bonds. Many bonds are required under statutes and designed to replace mechanics' lien remedies, which are not available on public works of improvement.[41] In the private sector there is no limit to the language used in a bond, the forms of which may come from the surety, bond producers, large contractors, owners, or industry associations such as the American Institute of Architects (AIA®). Generally, performance bonds guarantee the principal's obligation of performance of the bonded contract, subject to their terms and conditions and suretyship defenses.[42] The use of different bond forms[43] and the interpretation in various jurisdictions, plus differing application of law within these jurisdictions, may give obligees concerns about uncertainty in results.

For instance, the AIA A311 and the AIA A312 are two widely accepted and used performance bond forms. The AIA A311 form of performance bond has been in use for more than 40 years and continues to be used despite the creation of the AIA A312 form, published in 1984. The condition of the A311 form is:

> "NOW, THEREFORE, THE CONDITION OF THIS OBLIGATION is such that if the Contractor shall promptly and faithfully perform said Contract, then this obligation shall be null and void, otherwise to remain in full force and effect."

The A311 form requires that the principal be in default and be declared in default by the obligee of the bond and then provides that the surety may "promptly remedy the default."

Under this bond, the surety has one of several options: (i) complete the contract; (ii) obtain bids for the completion of the contract with the obligee selecting a contractor; or (iii) arrange for a contract between the completing contractor and the obligee, providing sufficient funds to pay the cost of completion less the balance of the original contract price. While there is no provision in the A311 bond form describing how an obligee must make a claim, some modern authorities hold that the obligee must declare a default and notify the surety of such in order for the surety to be liable.[44] As one might expect, there is also contrary authority.[45] Further, there is a contractual limitation period contained in the A311 bond requiring suit before the expiration of two (2) years from the date on which final payment under the contract falls due.

On the other hand, the AIA A312 - 1984 performance bond, which the AIA intended would supplant the AIA A311 bond, has no stated "condition" as does the A311 form but does provide:

> "2 If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond, except to participate in conferences as provided in Subparagraph 3.1."
>
> "3 If there is no Owner Default, the Surety's obligation under this Bond shall arise after:
>
> 3.1 The Owner has notified the Contractor and the Surety at its address described in Section 10 below that the Owner is considering declaring a Contractor Default and has requested and attempted to arrange a conference with the Contractor and the Surety to be held not later than fifteen days after receipt of such notice to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract…; and
>
> 3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract. Such Contractor Default shall not be declared earlier than twenty days after the Contractor and Surety have received notice as provided in Section 3.1;…."

Like the A311 bond, if the obligee (Owner) has properly declared a default and is not in default the surety's performance options are triggered. Like its predecessor, the A311, the bond contains a two year contractual limitation period (section 9) from the first date of (i) a Contractor Default was declared, (ii) the Contractor ceased working, or (iii) the Surety refuses or fails to perform.

More recently, the A312 - 2010 performance bond was a collaborative effort of a number of construction industry entities, including the American Institute of Architects, the ABA Forum Committee, Associated Builders and Contractors, Associated General Contractors of America, American Subcontractors Association, National Society of Professional Engineers, the Surety and Fidelity Association of America, and the American College of Construction Lawyers. The A312 - 2010 contains a number of substantive changes when compared to the A312 - 1984 form; in particular with respect to paragraph 3, which describes how the obligee (Owner) must proceed in terminating the bonded principal.

Finally, the ConsensusDOCS 260 performance bond, although using more modern language, contains very similar provisions to the A311 performance bond. The 260 performance bond includes the additional option to the surety: to "waive its right to complete the Work and reimburse the Owner the amount of the reasonable costs, not to exceed the Bond Sum, to complete the Work less the Contract Balance." The 260 performance bond also contains a contractual limitation period for the commencement of suit, requiring that any suit be commenced within two years after default of the principal or the substantial completion of the contract, whichever first occurs.

Making Claim on and Enforcing the Performance Bond

Enforcement of the bond should begin with reading the bond and, in the case of a public works bond, reading the statute or statutes pursuant to which the bond was written. Most performance bond forms that are used in private sector contracts contain: (1) a procedure for making claim, (2) a time after which claims are barred, and (3) a venue selection provision.

Insurance and suretyship should not be confused.

The A311 Performance Bond

The A311 performance bond provides that the principal "shall be" and be "declared by" the obligee to be in default. Thus, the Fifth Circuit, in *L&A Contracting Co. v. S. Concrete Service, Inc.*, 17 F.3d 106 (5th Cir. 1994), held the obligee must provide the surety a clear dec-

laration of default and an indication the underlying contract is terminated before the surety is obligated under the bond. A number of other courts have embraced the decision in *L&A Contracting*.[46] However, other courts reject the *L&A Contracting* holding, declining to find that the obligee's formal declaration and termination are conditions precedent to the surety's obligation.[47]

Further, some states will not enforce the contractual limitation clause of the A311 bond if it conflicts with a statutory limitation period.[48] One area of confusion is the time the A311 bond form limitation period actually commences. The express language states the period is measured from when final payment falls due under the underlying contract, leading to arguments in latent defect situations. In light of the bond language, obligees contend that final payment never in fact became due because the work under the contract was not properly performed. In *Yeshiva University v. Fidelity & Deposit Company of Maryland*,[49] a New York court held that the two year limitation was enforceable to bar a suit instituted more than five years after the obligee made final payment, despite the obligee's late discovery of a latent defect. The decision in *Yeshiva* may not be the final word on this issue.[50]

The ConsensusDOCS 260 Performance Bond

This bond form was first published in 2007 and there are no reported cases interpreting this bond. However, the terms of the ConsensusDOCS 260 performance bond are very similar to those contained in the A311 Performance Bond (except that it is a plain language form) and there is no reason to assume that a court would interpret the language of this bond significantly different than the A311 bond form. Like the A311, to make a demand on the surety, the principal (referred to in the bond as the "Constructor") must be "in default pursuant to the contract" and the obligee (referred to in the bond as the "Owner") must have declared the Constructor to be in default. The ConsensusDOCS 260 performance bond contains a two years contractual limitation provision from substantial completion of the work. The term "substantial completion" is a defined term in the contract documents. There is also a forum selection clause requiring suit in "any court of competent jurisdiction in the location in which the project is located."

The A312 – 1984 Performance Bond

This bond has pre-default requirements. Paragraph 3 requires the Owner to notify the principal (Contractor) and the surety that the owner is considering a declaration of default and then request a meeting within 15 days. Twenty days thereafter, the owner may declare a default. For the surety to perform, the owner must agree to pay the remaining contract funds to the surety. A majority of courts that have considered it conclude that the provisions contained in paragraph 3 of the A312 - 1984 performance bond are conditions precedent to the surety's obligation, such that the owner's failure to comply excuses the surety from performance.[51]

The A312 - 1984 performance bond contains both a contractual limitations provision and a forum selection provision, each contained in paragraph 9 of the bond. The forum selection provisions require that an action on the bond must be brought in a court of competent jurisdiction in the location where the work or any part of the work was performed. The limitations of actions provisions requires that suit be instituted within two years after the date of Contractor default, the date the Contractor ceased working on the contract, or the date the surety refused or failed to perform, whichever first occurs. There are several courts that have enforced the two year limitation period contained in the bond.[52]

The A312 - 2010 Performance Bond form is so new that there appear to be no judicial decisions interpreting its provisions. There are a number of substantive changes from the prior A312 - 1984 performance bond form, those with respect to paragraph 3 being of the most interest in this presentation. For instance, Paragraph 3.1 still requires the obligee (Owner) to notify the principal (Contractor) and the surety that the Owner is considering the declaration of a Contractor default. However, the Owner is not required to request a conference to discuss that issue. Paragraph 3.1 does permit the surety to request a conference as long as it does so within 5 days of receipt of the Owner's notice. The conference must be held within 10 business days after the surety received the Owner's notice.

Like the A311 bond, if the obligee (owner) has properly declared a default and is not in default, then the surety's performance options are triggered.

Paragraph 3.2 no longer requires that the Owner, in issuing a declaration of Contractor default, must wait 20 days following notice to the Surety and Contractor. It appears from the language of paragraphs 3.1 and 3.2 that the Owner is required to issue the paragraph 3.1 notice but need not wait for a conference to occur or for the passage of time after issuing the paragraph 3.1 notice before issuing a notice of default under paragraph 3.2.

The requirement of paragraph 3.3, for the Owner to commit to pay the contract balance, remains in the A312 - 2010 performance bond form.

Perhaps the most significant change in the A312 - 210 performance bond is the addition of paragraph 4, which provides that the failure of the Owner to comply with the notice requirements contained in paragraph 3.1 does not constitute the failure to comply with a condition precedent and releases the surety from its obligations under the bond only to the extent that the surety can demonstrate prejudice from the failure to comply. The forum selection clause and contractual limitations period contained in the A312 -2010 form are essentially the same as those contained in the A312 - 1984 form.

Surety Bond Cost and Enforcement Considerations

According to the Surety Information Office, the cost of surety bonds varies depending on the principal's characteristics and the surety company issuing the bond. Generally, the range of a premium is between .5 and 1.35 percent of the contract amount.[53] For this cost, an obligee (owner, general contractor, etc.) can obtain a 100% performance bond, a 100% payment bond, and often maintenance bonds too, because one premium typically covers all three bonds.[54] However, obligees should not expect immediate payment or performance in certain default situations. Unlike letters of credit, bonds are typically conditioned upon triggering events, including a proper default and performance from the obligee.[55] Instead, sureties are more realistically akin to an assurance that some party will answer for the principal's default if proven to be true in fact (i.e., solvency assurance). This has led to criticism of surety bond claims, which are perceived to often result in litigation.[56] A definite benefit of a surety bond is that the principal's bankruptcy does not typically prevent enforcement against the bond.[57]

A letter of credit is a primary obligation that depends solely on the beneficiary's presentation of conforming documents, with proof of the default being irrelevant in the absence of fraud.

Letters of Credit

Letters of credit are decidedly different than surety bonds. Letters of credit offer the "promise and premise [of] 'pay now, argue later.'"[58] Letters of credit are meant to provide risk allocation that is both certain and mechanical. Although performance bonds may be more prevalent in the construction industry, letters of credit offer owners and contractors certain benefits over performance bonds. Article 5 of the Uniform Commercial Code defines a letter of credit as a:

> a definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant, or in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.[59]

Many letters of credit are not governed under statutes at all, but instead international banking and commerce agreements such as the Uniform Customs and Practice for Documentary Credit (UPC), International Standby Practices (ISP),[60] or The United Nations Commission on International Trade Law (UNCITRAL) Convention of Independent Guarantees and Standby Letters of Credit.[61]

Letters of credit are not negotiable instruments, because they are not usually unconditional or payable on demand like a negotiable instrument, but instead are dependent on presentment of a separate draft or demand for payment.[62] The legal principles of "independence" and "strict compliance" govern letters of credit. Under the principle of "independence," letters of credit are deemed independent from the underlying transactions which they secure, such that they are unaffected by the merits of disputes regarding performance.[63] Accordingly, there is no duty of the issuer to investigate the default.[64]

Types of Letters of Credit

There are several different types of letters of credit. The most widely used are "commercial" letters of credit and "standby" letters of credit. Commercial letters of credit facilitate the sale of goods, particularly in international sales and serve as the payment mechanism.[65] The purpose of standby letters of credit is to guard against non-performance on an underlying agreement.[66] Issuing banks do not presume they will pay under standby letters and credit, and only about 0.03% of all standby credits end up as losses to the bank.[67]

Although some courts appear confused between standby letters of credit and guarantees,[68] because both are intended to answer for a default of an underlying agreement,[69] the two devices are different and distinct from one another.[70] As explained above, surety bonds and guarantees are secondary obligations, contingent upon default of the underlying agreement.[71] Thus, a surety or guarantor investigates whether a default has in fact occurred,[72] and has no obligation until the default has been factually established.[73] By contrast, a letter of credit is a primary obligation[74] that depends solely on the beneficiary's presentation of con-

forming documents, with proof of the default being irrelevant[75] in the absence of fraud.[76]

Letters of credit may also be either revocable or irrevocable, and "clean" or "documentary." A revocable letter of credit may be unilaterally amended or canceled at any time prior to the beneficiary's presentation; whereas, an irrevocable letter of credit may not be amended or canceled without the beneficiary's consent until the term for presentment expires.[77] Letters of credit are presumed irrevocable.[78] Most standby letters of credit are also "documentary," in that certain documentation must accompany presentment of a draft for payment. A "clean" letter of credit is payable solely with presentation of a draft.[79] Under any of the various types of letters of credit, the presenter must make the presentation within the effective time period and presentation must strictly comply,[80] with certain limited exceptions.

Costs and Enforcement Considerations

The fee and costs of letters of credit are annual and typically a small percentage (1%) of the amount of the letter of credit, although all applicants except those extremely well-heeled must fully collateralize the issuer for the life of the letter of credit.[81] For this reason, letters of credit to secure construction obligations are often in an amount that is a small percentage (i.e., 10% - 20%) of the underlying contract's price. Timely and proper presentation is mandatory.[82] While most letters of credit are relatively simple to enforce upon timely and proper presentation, there are some relatively rare instances when a draw on a letter of credit can be blocked through injunction based on fraud.[83] Finally, just like surety bonds, the bankruptcy of the underlying applicant for which the letter of credit is provided does not generally affect enforcement against the issuer of the letter of credit.[84]

Subcontractor Default Insurance

In 1995, Zurich N.A. Insurance Company established a product known as "Subguard"® to protect against defaults.[85] Since then, Arch and XL Group have offered similar insurance products.[86] While apparently available to both owners and contractors,[87] it appears its target purchaser is a general contractor with a high volume of subcontracted work (e.g., $50 million to $75 million) annually in private works construction projects.[88] On the other hand, subcontractor default insurance was used recently in a public works construction-manager at risk project for Ohio State University, despite challenges from the subcontractor industry and surety industry.[89]

The policy is first party insurance between the insured and insurer.[90] Policy limits can be as high as $50 million single loss, and $150 million aggregate.[91] The policy requires insureds to pre-qualify their subcontractors.[92]

> If a contractor [ ] is not willing or able to effectively qualify its subcontractors, then default insurance is probably not the correct vehicle to look toward for protection, and coverage should not be offered under those circumstances.[93]

Thus, it appears best suited for general contractors who can work with known subcontractors repeatedly, or contractors that can quickly and efficiently pre-qualify new subcontractors. Contractors that use insurer approved prequalification services may get discounts on pricing. Advocates of its use contend it is an effective alternative to surety bonds in certain circumstances.[94]

Default Insurance Coverages

Upon a covered subcontractor's default in performance, the policies typically cover:

- the cost of completing the work,
- loss due to the subcontractor's non-payment to third parties (e.g., unpaid labor, material or lower tier subcontractors or suppliers);
- loss due to corrections of defective or non-conforming work (on an excess insurance basis – in other words, assuming no coverage or exhaustion of other insurance coverage);
- legal and professional costs;
- indirect losses, such as liquidated damages, extended overhead, acceleration and other similar losses if caused from the subcontractor's default (which may be subject to sub-limits on a per policy basis); and
- construction defects after completion on an excess coverage basis (i.e., assuming no coverage of exhaustion of other insurance).[95]

One commentator described subcontractor default insurance as follows:

> SDI is a type of self-insurance and therefore does not provide first dollar coverage. Rather, the insured is responsible for a large deductible, which, although negotiable, normally ranges from $350,000 to as much as $2 million per loss.[] The deductible is normally followed by a co-pay layer [… that] often ranges from $1 million to $5 million. … Once the deductible and co-pay requirements are satisfied, then the insurer is liable for any additional costs up to the single loss policy limit on a dollar for dollar basis.[96]

Typical exclusions apply for bonded subcontractors, sub-subcontractors, acts of dishonesty and fraud, misrepresentation, and design professional services unless incidental to the construction.[97]

Default Insurance Cost and Enforcement Considerations

Cost appears to be negotiable, and is based in part on default loss experience over time, after the insured exhausts its deductible.[98] Premium costs are insured specific and reportedly comparable to that of surety bonds, ranging from .85 percent to 1.35% of the subcontract amounts.[99] These costs do not factor in the deductible costs or co-payments in the event of a loss, which can range from low six figures ($250,000) to seven figure amounts.[100] Additionally, some insurers require the insured to guarantee a minimum premium amount over the course of three to five years.[101] The policy pays out after a declaration of default, notice, submission of a proof of loss and proof of payment of applicable deductible.[102] The insurer reimburses the insured for covered losses, after deductible, within a short time of receipt of an approved proof of loss.[103]

The insurers are subrogated to the losses of the insured against the defaulted subcontractor, and the insured must cooperate with the insurer in the recovery effort.[104] An interesting aspect which insureds should also consider, the insurance company's payments under the policy are made with the express reserved right to be reimbursed from the insured if a court or other tribunal ultimately finds the insured's declaration of default was in error.[105] Unlike surety bonds in some jurisdictions, however, the insurer would be subject to bad faith tort claims if it denies a claim in bad faith.[106]

Parent Company Guarantees

A corporate guarantee from a parent company or affiliate of the contractee is subject to the law of guarantee and suretyship in the relevant jurisdiction.[107] A guarantee is akin to a suretyship obligation, and some states have abolished distinctions between the two.[108] However, other jurisdictions hold the distinction between the two as follows:

> a contract of guaranty is distinguishable from a contract of surety, in that the obligation of a surety is primary, while that of a guarantor is collateral. While each is, as to the principal, collaterally liable, as to the creditor or obligee the surety is primarily and directly liable on his or her contract from the beginning, whereas the liability of the guarantor is secondary and is fixed only by the happening of the prescribed condition at a time after the contract itself is made.[109]

There are two main points to the distinction in substantive law. First, the surety is generally not entitled to notice of default unless its bond so provides, whereas the guarantor is so entitled to timely notice as a condition of liability.[110] Second, some states restrict the right of the plaintiff to include the guarantor in the suit with the principal obligor, in light of the secondary and separate nature of the guaranty.[111]

Parent guarantees seem to be catching on as security for contractual performance in certain circumstances. Though the compensated surety's bond premium may be avoided and a cost savings realized, guarantees of parent or affiliated companies to the contracting party come with some special considerations. First, the parent or affiliate is highly if not certainly likely to side with the defaulted principal obligor in any contested default, so any expectation of a independence in review and investigation should be tempered. Additionally, there may be issues of consideration and jurisdictional challenges to be met in attempting to enforce them.[112] Overall, a corporate guaranty is similar to a surety obligation in that it is solvency protection – though not backed with a state insurance guarantee fund.

Performance Risk Challenges Presented in Design-Build & IPD Delivery Systems

Design – Build Delivery System

Under the design-build delivery system, instead of separately contracting with a designer and contractor, the owner enters one contact with a design-build entity.[113] There are multiple ways to structure the contracts to effect the design-build project, including a constructor as design-builder, a joint-venture as design-builder, and a designer as design-builder, each of which contractually engaged necessary other parties unless the firm possesses both design and construction capabilities.[114] Proponents contend:

> One of the prime selling points to a prospective owner with the design-build method of delivery is "single-point responsibility." The implications of this compared to other project delivery methods is obvious. … The design-build contractor agrees to take the risk for both the design and construction of the project.[115]

On the other hand, the owner does not give up full control, because the owner sets the design criteria and often has the right to review and modify design documents.

Design-build projects are not without risks and disputes. The parties shared design responsibilities and "bridging" has

Design-build projects are not without risks and disputes.

risks and may lead to disputes over purportedly inaccurate preliminary design criteria.[116] There are also some special considerations if a single purpose entity is created to act as the design builder, including solvency, licensing and alter ego issues.[117] Still, there are numerous studies and commentaries lauding the advantages of design-build in certain contexts, including potential time and cost savings,[118] such that it is likely to gain market share and numerous standard forms are now available for design-build projects (e.g., AIA® and ConsensusDOCS®, among others).

Surety Bonds and Design-Build

When design-build became more popular and sureties were approached for bonds, sureties expressed a number of concerns over issuing bonds for design-build contractors. Surety concerns included the perception of increased obligations for design, with limited options for performing if the design-build principal defaults.[119] Due to these concerns, some sureties request riders or alterations of the bond and contract forms to clearly exclude the surety from design responsibility.[120] As design-build becomes more commonplace, sureties seem to be more agreeable to bonding design-build contracts, especially where the constructor has a track-record of successful results on similar jobs.[121]

Other factors that may affect whether surety bonds will be issued to secure the design-build contract include:

- The constructor's history and type and size of work,
- The reputations and historical relationships among contractor, designer and owner,
- The design-build contract terms, including the risk of consequential damages,
- The contractual arrangement, including whether it is special purpose entity, contractor, or design firm lead, and
- Other insurance products protecting against design and other risks, including project specific contractor's protective professional indemnity policies.[122]

Sureties may also charge a larger premium, or surcharge premium, for design build work, that can be 25% to 50% more than traditional design-bid-build jobs.[123] However, sureties may also be willing to waive the surcharge depending on the bond principal, job circumstances, and insurance protections in use.[124] From an owner point of view, surety protection on a design-build project certainly seems appropriate, as a belt and suspender protection from the design-builder's default. Since it is common in design-build contracts to let out certain subcontracts after design on a hard price basis, design-builders often also bond their subcontractors.

Like surety bonds, the concept of hedging against contractual nonperformance with a letter of credit for an IPD core contracting party seems like a contradiction in theory.

Letters of Credit and Design-Build

Letters of credit are considerably easier to obtain in that banks simply require exceptional financial cash balances or cash-collateral from applicants to secure them. On the other hand, because of the security requirement, letters of credit are usually much less than the contract price and this may cause owners and general contractors some pause about whether they are adequately protected. Further, as discussed above, letters of credit offer one-way protection to the beneficiary against the applicant's performance default, after timely and proper presentation. To the extent the proceeds are insufficient, there is no protection against lower – tier claims from subcontractors, suppliers, laborers, and a host of other potential liabilities and risks.

Subcontractor Default Insurance

For the large owner or general contractor on design-build projects, default insurance may be a way to hedge against lower tier subcontractor defaults. Especially in private works settings, there may be some attractive characteristics to default insurance over surety bonds and letters of credit because (i) price alone is not the only factor in selection, (ii) the design-builder could gain the most benefit from the pre-qualification requirements long-term subcontractor relationship, and (iii) maintaining schedule is more proportionately the design-builder's risk, such that control of the remedy for default may have more value. As noted above, public owners are often restricted from its use in public works,[125] at least one court found subcontractor default insurance in combination with a letter of credit acceptable as a substitute for bonds.[126]

Integrated Project Delivery System

In response to perceived "fragmentation" and poor productivity in the construction industry, a few owners have embraced "lean" concepts and collaborative agreements for construction known as "integrated project delivery,"[127] or "IPD." The main concept behind IPD is "to align the commercial interests of the major project participants and govern the delivery

process as a collective enterprise."[128] The goal of the IPD agreement is to eliminate traditional focus on risk transfer, and instead emphasize the relational aspects of the team charged with delivering the project.[129]

The IPD agreement is

> a relational contract … [that is] signed by the architect, the construction manager/general contractor (CM/GC) and owner … describ[ing] how they [are] to relate throughout the life of the project. …[¶] The [IPD agreement] seeks to create a system of shared risk, with the goal of reducing overall project risk, rather than just shifting it. In part, this goal is supported by investing significant efforts in up-front collaboration, with the owner funding early involvement of the project team … The CM/GC is compensated on a cost-plus fee basis with either a guaranteed maximum price (GMP) or an estimated maximum price (EMP). An EMP operates as a pain and gain sharing threshold, but limits the potential losses to the IPD team at their collective profit, keeping with the owner the risk of more significant cost overruns. [¶] [Instead of] separate contingency amounts for design issues and construction issues[, t]he [IPD agreement] combines these contingencies into one IPD team contingency.[130]

The core group of team members sets criteria and decides how the project contingency will be shared, which IPD advocates contend enhances productivity, and reduces project duration, cost and injuries.[131] IPD can be pursued through collaborative agreements, design assist agreements, or single purpose entities.[132] Beyond the core group and signatories to the IPD agreement, risks for certain procurements in delivery of construction services, materials and equipment may be contracted out on a full risk basis.

Both ConsensusDOCS® and AIA® have produced form contracts intended for use on IPD projects in ConsensusDOCS 300 and AIA A295. The extent to which each of the form agreements truly capture the concepts of integrated project delivery is not without debate.[133] For instance, AIA A 295, Article 1.3.9 states:

> [The agreements] shall not be construed to create any contractual relationship of any kind … between the Contractor and the Architect or the Architect's consultants … The Architect shall, however, be entitled to performance and enforcement of obligations under the Contract intended to facilitate performance of the Architect's duties.

This provision seems in stark contradiction with the theories behind true IPD relational agreements.

In practice, it appears many projects attempting to use IPD theories are applying collaboration and shared risk and reward agreements only to some teams (e.g., the constructor/designer in design-build), but not the entire core construction team.[134] Additionally, insuring the IPD project may be a challenge that requires modifications to some endorsements or manuscript policies.[135]

Surety Bonds & IPD

At its core, the concept of surety bonds to secure the risk of non-performance seems in contradiction to IPD theory, which jointly obligates the IPD contracting parties to collaborate and share risk and reward toward a common performance criteria. Indeed, a common condition of a surety's obligation is the obligee's performance. How can the obligee's performance be measured and determined if the principal and obligee are jointly charged with the obligation to collaborate together to jointly achieve the performance?

For these reasons, sureties have struggled with questions about underwriting bonds for contractors in IPD projects. Common questions and concerns include:

- Who covers the design risks?
- Given these untraditional roles and relationships, does the principal have sufficient experience to justify surety credit (i.e., capability)?
- The scope of the obligation seems fuzzy, or not clearly defined. Is the surety expected to cover the ambiguities or vagueness?
- What warranties is the surety expected to guarantee, especially where design and construction obligations are shared?[136]

Thus, core group contractors may have difficulty obtaining surety bonds for an IPD project where it is their first endeavor unless they can show experience with the owner and designer, plus the surety is likely to limit its exposure, exclude design and warranty responsibility, and manuscript the bond language to add conditions on its obligation.[137] For non-core group participants with defined scopes and risk, obtaining surety bonds would seem quite routine and appropriate.

Letters of Credit & IPD

Like surety bonds, the concept of hedging against contractual non-performance with a letter of credit for an IPD core contracting party seems like a contradiction in theory. However, to the extent a surety bond or letter of credit can be prepared to cover the primary risk of insolvency protection, either would seem appropriate and reasonable given the likely damages to the other project participants if one of the core contractees had to abandon an IPD agreement due to its financial woes. Generally, neither letters of credit nor bonds, as explained above, are considered part of the bankruptcy estate.

Between the two, standby letters of credit are likely to result in faster cash relief given the principle of independence, which would assist the core group as it searches for a replacement of its defaulted member, but surety bonds might afford greater eventual relief if insolvency were truly principal's basis for default because letters of credit are typically for amounts equal to a small percentage of the contract price estimate, while surety bond amounts are typically 100% of the contract price. With respect to non-core group IPD contractors and suppliers, traditional approaches to surety bonds and letters of credit

Subcontractor Default Insurance

With respect to the construction aspects of IPD projects, default insurance in conjunction with other policies, may be a viable option.[138] Some considerations for default insurance in IPD projects include:

- Larger projects may justify large deductibles and co-pays;
- Endorsements may allow coverage for CM/GC, owner and designer;
- May cover design/build subcontractors so long as design obligations are "incidental;"
- Insurers may be able to accommodate risk/reward sharing of IPD agreement; and
- Damages (after deductible and co-pay) are not limited to the amount of the subcontractor's agreement if larger limits are provided.[139]

In short, there may be some advantages to default insurance on very large projects where time is critical to the overall delivery goals.

Conclusion

Today's owner and general contractor has a number of choices to secure contractual performance from its contractee. The main choices of surety bonds, letters of credit, default insurance, and guarantees all have certain risks and costs. A careful evaluation of each should be undertaken in the context of each project and party to a contract, and the overall cost of option and risk involved should be evaluated as well. There are no mechanical applications to this process and the risk involved in each choice is most probably determined by the contractee. However, like stocks and bonds, a mix and assortment of these options might result in the best long term return on investment.

Endnotes

1 Philip L. Bruner & Patrick J. O'Connor, Jr., 2 Bruner & O'Connor On Construction Law § 6:1 (6th Ed., 2005) (hereafter, "Bruner & O'Connor on Construction Law").

2 See, 2 Bruner & O'Connor On Construction Law § 6:1.

3 *U.S. v. Spearin* (1918) 248 U.S. 132, 54 Ct. Cl. 187, 39 S.Ct. 59, 63 L.Ed. 166.

4 Id.

5 See, Design Professional & Construction Manager Law, Chap. 6, pp. 145-160 (S. Hess, J. Bales, P. Folk & L. Holt; ABA 2007)

6 2 Bruner & O'Connor on Construction Law §6.4, p. 505.

7 See, Isidore, Chris (CNN Money Sr. Writer), "The Great Recession : Economists Generally Agree this is the Worst Economic Downturn Since the Great Depression …." (March 25, 2009, CNN Money.com) [http://money.cnn.com/2009/03/25/news/economy/depression comparisons/]

8 See, Nasiripour, Shahien, "Which Industries Lost/Gained Jobs in the Great Recession," (April 5, 2010, Huffington Post) [http://www.huffingtonpost.com/2010/04/05/which-industries-lostgain n 525504.html]

9 FMI Special Report, 2011 Surety Providers Survey (reprinted with permission from FMI Corporation).

10 See, generally, 2 Bruner & O'Connor on Construction Law, Ch. 7 (Risk Management: Identifying, Allocating and Mitigating Construction Risks).

11 See, Construction Insurance | A Guide for Attorneys and Other Professionals (S. Palley, T. Delahunt, J. Sandberg & P. Wielinski; A.B.A. 2011)

12 See, e.g., AIA Document A101 – 2007 (Standard Form of Agreement Between Owner and Contractor); AIA B101 – 2007 (Standard Form of Agreement Between Owner and Architect).

13 For instance, construction contracts often contain detailed provisions for damages, including liquidated damages for delays, and dispute resolution procedures based on breach of contract theories, such as those found in AIA and Consensus DOCs form contracts.

14 In addition to breach of contract theories, common law theories such as quantum meruit, money had and received, account stated, and other theories may be available to an aggrieved party.

15 For example, every state in the United States has mechanics' lien statutory rights on private works and bond rights on certain public works (See, Fifty State Construction Lien & Bond Law (R. Cushman, S. Butler, 2d ed. Aspen Law & Business 2000)), and many have prompt payment and other statutory remedies for aggrieved parties.

16 *See, e.g., Wm. R. Clarke Corp. v. Safeco Ins. Co. of America* (1997) 15 Cal.4th 882, 938 P.2d 372, 64 Cal.Rptr.2d 578, where – absent the bond and the California Supreme Court's ruling that pay-if-paid clauses are against public policy – lien rights would have been worthless due to the insolvency of the owner and insufficient value in the property.

17 See, e.g., 4A Bruner & O'Connor Construction Law § 12:11; Principles of Suretyship (J. Fitzgerald, R. Britt, D. Waldorf; 2d Ed., 2010 – The Institutes, Malvern, PA).

18 See, generally, The Surety's Indemnity Agreement: Law and Practice (M. Klinger, G. Bachrach, T. Haley; 2d Ed. 2008)

19 See, e.g., 4A Bruner & O'Connor Construction Law § 12:11; Principles of Suretyship, Ch. 5 (J. Fitzgerald, R. Britt, D. Waldorf; 2d Ed., 2010 – The Institutes, Malvern, PA).

20 Id.

21 See, AON Surety Market Update, 2009 – Special Edition – Surety Assoc. of America Announces 2008 Year-End Results (http://www.aon.com/attachments/Surety_News_Letter_Spring_09.pdf).

22 Carved in the stone at Delphi it is written, "Act as surety, and thy ruin is at hand." "The 'Seven Sages of Greece' (c. 620-550 B.C.) was the title given by Greek tradition to seven wise ancient Greek men who were philosophers, statesmen and law-givers. They were philodorians. The Seven Sages are known for their practical wisdom which 'consisted mostly of pithy and memorable dicta.' Later, they met at Delphi to dedicate their wise sayings to the god Apollo. Socrates provides the earliest list of the so called Seven Sages…[quoting] Thales of Miletus 'To bring surety brings ruin.'" See, www.worldhistory.com/wiki/S/Seven-Sages-of-Greece.htm, citing Protagoras, Plato, 434a-b; Harper's Dictionary of Classical Literature and Antiquities, H. Thurston Peck, ed., Cooper Square Publ., 1962; and Brush Up Your Classics, M. Macrone, Gramercy Books, NY, 1991.

23 Proverbs, 6:1-2, 11:15, 17:18, and 22:26 (E.g., "He that is surety for a stranger shall smart for it: and he that hateth surety is sure." Proverbs, 11:15).

24 "A debtor's sureties shall not be distrained upon so long as the debtor himself can discharge his debt. If, for lack of means, the debtor is unable to discharge his debt, his sureties shall be answerable for it. If they so desire, they may have the debtor's lands and rents until they have received satisfaction for the debt that they paid for him,

Endnotes continued

unless the debtor can show that he has settled his obligations to them." Magna Carta, The Greater Charter of English liberty granted by King John at Runnymede on June 15, 1215. (See, "www.britannia.com/history/magna2.html" for full text.)

25 See generally, Rest. (3rd) Law of Suretyship & Guarantee, The American Institute of Law (1996); The Law of Performance Bonds (L. Moelmann, M. Horowitz, K. Lybeck, 2d ed., A.B.A. 2009); The Law of Payment Bonds (W. Lambert, K. Lybeck, and J. Sebastian, 2d ed., A.B.A. 2011).

26 See, 4A Bruner & O'Connor Construction Law § 12:5.

27 *Belloni v. Freeborn*, 63 N.Y. 383 (1875); *Joint School District v. Bailey-Marsh Co.*, 181 Wis. 202, 194 N.W. 171 (1923); *Shreffler v. Nadelhoffer*, 133 Ill. 536, 25 N.E. 620 (1890); *National Union Fire Insurance Co. v. Nevils*, 217 Mo.App. 630; 274 S.W. 503 (1925).

28 226 N.Y. 13, 122 N.E. 449 (1919).

29 W. D. Morgan, *The History in Economics of Suretyship*, 13 Cornell L.Q. 487, 491-92 (1927).

30 *United States Fidelity & Guaranty Company v. Poelker*, 180 Ind. 255, 102 N.E. 372. (1913). To the same effect, *see*, *American Surety Company v. Pauley,* 170 U.S. 133, 18 S. Ct. 552 (1898) and *Royal Indemnity Co. v. Northern Ohio Granite & Stone Co.*, 109 Ohio St. 373, 126 N.E. 405 (1919).

31 Rest. (3rd) Law of Suretyship & Guarantee, The American Institute of Law (1996).

32 Rest. (3rd) Law of Suretyship & Guarantee, §1, The American Institute of Law (1996).

33 Id.

34 Id.

35 See, generally, 4A Bruner & O'Connor Construction Law § 12:9.

36 See, Id.

37 See, e.g., 4A Bruner & O'Connor Construction Law § 12:11; Principles of Suretyship (J. Fitzgerald, R. Britt, D. Waldorf; 2d Ed., 2010 – The Institutes, Malvern, PA).

38 See, Surety Information Organization, www.sio.org – 10 Things You Should Know (http://suretyinfo.org/?page_id=185)

39 See, generally, The Law of Performance Bonds, supra, note 22.

40 See, generally, The Law of Payment Bonds, supra, note 22.

41 See, 1-3 Fifty State Construction Lien & Bond Law (R. Cushman, S. Butler, 2d ed. Aspen Law & Business 2000.

42 See, generally, The Law of Performance Bonds (L. Moelmann, M. Horowitz, K. Lybeck, 2d ed., A.B.A. 2009).

43 Presumably, if obligees were sophisticated consumers of surety bonds and powerful enough, they could manuscript the bond forms to eliminate some of the uncertainty.

44 *Moore Construction Co. v. Clarksville Department of Elect.*, 707 S.W.2d 1 (Tenn.App.1985); *L & A Contracting Co. v. S. Concrete Service, Inc.*, 17 F.3d 106 (5th Cir.1994); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Ironworks*, 986 F.Supp. 82 (D.Conn.1997); *Elm Haven Construction Ltd. v. Neri Construction, LLC*, 376 F.3d 96 (2nd Cir.2004); *Hunt Constr. Group, Inc. v. National Wrecking Corp.*, 587 F.3d 1119 (D.C.Cir.2009).

45 *Nova Casualty Co. v. Turner Construction Co.*, 2011 WL 480599 (Tex.App.2011); *Colorado Structures, Inc. v. Insurance Company of the West*, 169 P.3d 1125 (Wash.2007); *Walter Concrete Construction Corp. v. Lederle Laboratories*, 99 N.Y.2d 603, 788 N.E.2d 609 (N.Y.2003).

46 See, *Moore Construction Co. v. Clarksville Department of Elect.*, 707 S.W.2d 1 (Tenn,App.1985); *L & A Contracting Co. v. S. Concrete Service, Inc.*, 17 F.3d 106 (5th Cir.1994); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Ironworks*, 986 F.Supp. 82 (D.Conn.1997); *Elm Haven Construction Ltd. v.Neri Construction, LLC*, 376 F.3d 96 (2nd Cir.2004); *Hunt Constr. Group, Inc. v. National Wrecking Corp.*, 587 F.3d 1119 (D.C.Cir.2009).

47 See, *Nova Casualty Co. v. Turner Construction Co.*, 2011 WL 480599 (Tex.App.2011); *Colorado Structures, Inc. v. Insurance Company of the West*, 169 P.3d 1125 (Wash.2007); *Walter Concrete Construction Corp. v. Lederle Laboratories*, 99 N.Y.2d 603, 788 N.E.2d 609 (N.Y.2003).

48 Arizona, Connecticut, South Dakota,Texas, Vermont and West Virginia are among the states that have adopted statutes regulating the time that may be provided by contractual limitation provisions for actions against insurers, sureties or others.

49 116 A.D.2d 49 (N.Y.App.Div.1986).

Endnotes continued

50 See the decision in *Clyde-Savannah School District v. Naitzker, Thorsell & Dove*, 73 A.D.2d 810 (N.Y.App. 1979) and the decision in *City of Santa Fe v. Travelers Casualty & Surety Company,* 228 P.3d 483 (N.Mex. 2010). These decisions do not involve the A311 performance bond but do reflect the rationale applied by a court to avoid the application of a contractual limitation provision.

51 *Stonington Water Street Association v. Hodess Building Co.*, Inc., 2011WL861688 (Conn.2011); *Travelers Casualty and Surety Company v. Crystal Towers, LLC*, 2009WL5068823 (Ala.2009); Enterprise Capital, Inc. v. San-Gra Corp., 284 F.Supp.2d 166 (D. Mass.2003).

52 See, e.g., *ADP Marshall, Inc. v. Noresco, LLC.*, 710 F.Supp.2d 197 (D.R.I. 2010).

53 See, Study Guide, Posted by Surety Information Office on October 5, 2011, What Are Surety Bonds? (www.sio.org).

54 Id.

55 See, The Law of Performance Bonds, supra, note 22.

56 See, A. Ferrini, *The Bottom Line – Project Bonding Alternatives Offer Benefits and Risk*, New York Construction, June 2006 (http://newyork.construction.com/opinions/bottomline/archive/2006/06.asp).

57 See, S. Rittmaster, Ch 1 "Bankruptcy 101," The Surety and Bankruptcy, (J. Wilcox, et al. (eds) ABA 2010), p. 20, fn 69. "A corollary to this rule is that pending a decision by the debtor to either accept or reject an executory contract, the other party to the contract is required to continue to perform the terms and conditions of the contract with the debtor, even though the debtor may not be performing its own obligations." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984). See *also, e.g., United States Postal Serv. v. Dewey Freight Sys.*, Inc., 31 F.3d 620, 624 (8th Cir. 1994) ("After a debtor commences a Chapter 11 proceeding, but before executory contracts are assumed or rejected under section 365(a), those contracts remain in existence, enforceable by the debtor but not against the debtor."); *In re Nat'l Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) ("The non-debtor party must continue to perform under the contract prior to assumption or rejection….")

58 *Eakin v. Continental Ill. Nat'l Bank and Trust Co. of Chicago*, 875 F.2d 114, 116 (7th Cir. 1989) (Easterbrook, J.); See also Dunn, Knoll, and Demsey, *Letters of Credit in Construction Projects*, 29 Constr. Law. 33 (Winter 2009) (discussing the types of letters of credit used in connection with construction projects).

59 UCC § 5-102(a)(10) (revised 1995).

60 Copies of the UCP and ISP rules may be obtained through the International Chamber of Commerce website (www.iccwbo.org).

61 See, Convention on Independent Guarantees and Standby Letters of Credit arts, Dec. 11, 1995, 2169 U.N.T.S. 190 (www.uncitral.org).

62 *See United Technologies Corp. v. Citibank*, 469 F. Supp. 473, 478 (S.D.N.Y. 1979).

63 See, e.g., *Eakin v. Continental Ill. Nat. Bank & Trust Co. of Chicago*, 875 F.2d 114 (7th Cir. 1989).

64 See, Dunn, Knoll, and Demsey, *Letters of Credit in Construction Projects*, supra, note 44, 29 Constr. Law at 37.

65 1 Corporate Counsel's Guide to Letters of Credit, §1:2 (2007).

66 Id.

67 *Id.* at §1:92.

68 See *Ochoco Lumber Company v. Fibrex & Shipping Company Inc.*, 994 P.2d 793 (Or. 2000).

69 *Paladino*, 389 A.2d 454.

70 *See* UCC § 5-103, cmt. 1.

71 Id.

72 *See generally*, E. Gallagher, The Law of Suretyship (2d ed. 2000).

73 E.g., *Cates Construction, Inc. v. Talbot Partners*, 21 Cal.4th 28, 86 (Cal. Ct. App. 1999). In particular, as the Supreme Court of California stated:

> A surety is "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor." . . . A surety bond is a " 'written instrument executed by the principal and surety in which the surety agrees to answer for the debt, default, or miscarriage of the principal.'" . . . In suretyship, the risk of loss remains with the principal, while the surety merely lends its credit so as to guarantee payment or performance in the event that the principal defaults. . . . In the absence of default, the surety has no obligation.

Id. at 38.

74 John F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credit*, Section 2.01 (A.S. Pratt ed., rev. ed. 2003).

75 *New York Life Ins. Co. v. Hartford Nat'l Bank, & Trust Co.*, 378 A.2d 562 (1977).

76 See, Dunn, Knoll, and Demsey, *Letters of Credit in Construction Projects*, supra, note 44, 29 Constr. Law at 36.

77 *See* Dolan, *supra* note 62, Section 2.10(1).

78 UCC § 5-106(a).

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79 J. White and R. Summers, Handbook of the Law under the Uniform Commercial Code, § 18-1 (1972).

80 See, Dunn, Knoll, and Demsey, *Letters of Credit in Construction Projects*, supra, note 44, 29 Constr. Law at 36.

81 See, e.g., M. McIntyre & D. Dtrischek, *Our Letters Are Not Their Bonds: The Difference Between a Bank Letter of Credit and a Surety Bond*, The RMA Journal, p. 62 (Feb. 2006) ("By and large, contractors do not qualify for unsecured credit commitments, so their LC requests must be collateralized. However, excess liquidity is not typical of contractors, either.").

82 See, Dunn, Knoll, and Demsey, *Letters of Credit in Construction Projects*, supra, note 44, 29 Constr. Law at 36.

83 See, Henry Harfield, *Enjoining Letter of Credit Transactions*, 95 Banking L. 596 (1978).

84 See, Dunn, Knoll, and Demsey, *Letters of Credit in Construction Projects*, supra, note 44, 29 Constr. Law at 38.

85 T. Gray, *Point/Counterpoint: Default Insurance – An Alternative to Traditional Surety*, 22 Constr. Law. 17 (Winter 2002) (hereafter, "T. Gray, *Point/Counterpoint*").

86 See, e.g., XL Group's policy named "ConstructAssure." (www.xlgroup.com/xlg/share/pressrelease_ detail.jsp?id=1420&lobbyname=news); Arch policy through Construction Risk Underwriters (www.crunderwriters.com).

87 T. Gray, *Point/Counterpoint*, supra note 72, 22 Const. Law. at 17 (Winter 2002).

88 J. Bosick, *Subguard Insurance – A General Contractor's Risk Management Option for Defaults by Subcontractors*, The Critical Path (vol. 1, Issue 8; April 2009) (Defense Research Institute).

89 *State ex rel. American Subcontractors Ass'n, Inc. v. Ohio State Univ.*, 940 N.E.2d 984 (Ohio 2011).

90 4 Bruner & O'Connor On Construction Law §11:317.

91 See, Zurich Subguard® promotional summary (2009 – form A1-11329-S (08/2009) 09-2743) (http://www.zurichna.com/NR/rdonlyres/D8ABD9F0-95AE-4B06-B58C-1087399A2D46/0/Subguard.pdf) .

92 See, T. Gray, *Point/Counterpoint*, 22 Constr. Law. 17, at 18-19.

93 Id.

94 See, Id.

95 I. Houston, *Use of Subcontractor Default Insurance During the Global Financial Crisis – A Practitioner's Perspective*, 2011 J. Canadian C. Constr. Law. 27, at 33 (2011).

96 I. Houston, *Use of Subcontractor Default Insurance During the Global Financial Crisis – A Practitioner's Perspective*, 2011 J. Canadian C. Constr. Law. 27, at 33 (2011).

97 Id.; See also, e.g., Arch SDI policy 00 GL0581 00 08 11 provision 2(g).

98 See, e.g., T. Gray, *Point/Counterpoint*, 22 Constr. Law. 17, at 18-19; Peckar & Abramson, *An Alternative to Performance Bonds – Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor*, Lorman Newsletter (Constr. Update – Sept. 2005).

99 Id.

100 See, J. Bosick, *Subguard Insurance – A General Contractor's Risk Management Option for Defaults by Subcontractors*, The Critical Path (vol. 1, Issue 8; April 2009) (Defense Research Institute); Peckar & Abramson, *An Alternative to Performance Bonds – Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor*, Lorman Newsletter (Constr. Update – Sept. 2005).

101 Special thanks to Keith Newell, Sr. V.P., of Heffernan Insurance Brokers in Los Angeles, California, (www.heffins.com), for his insights.

102 See, e.g., Arch policy 00GL0581 00 08 11.

103 See, T. Gray, *Point/Counterpoint*, 22 Constr. Law. 17, at 18-19.

104 Id.

105 Id.; See, e.g., Arch SDI policy 00 GL0581 00 08 11 provision 6(h) ("You must immediately return any payments made by us upon a determination by a court, arbitrator, arbitration panel or other legally binding determination that the Loss does not arise out of a Default of Performance.").

106 See, Peckar & Abramson, *An Alternative to Performance Bonds – Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor*, Lorman Newsletter (Constr. Update – Sept. 2005).

107 See, generally, Rest. (3rd) Law of Suretyship & Guarantee, The American Institute of Law (1996); 38A Corp. Juris Sec. Guaranty §1 *et seq*.

108 See, 38A Corp. Juris Sec. Guaranty §7; Cal. Civ. Code §2787 ("The distinction between sureties and guarantors is hereby abolished …")

109 38A Corp. Juris Sec. Guaranty §7.

110 38A Corp. Juris Sec. Guaranty §7.

111 Id.

112 See, e.g., *La Quinta Motor Inns v. Schmelig Constr. Co., Inc.*, 617 S.W.2d 827 (Tx. App. 14th Dist., 1981); *Gunton Corp. v. KNZ Constr., Inc.*, (Del. Sup. 1999) 1999 WL 744423 (unpub. Decision).

113 See, 2 *Bruner & O'Connor on Construction Law* §6:15.

114 See, e.g., K. Kester, J. Heisse, J. Schenck, The Design-Build Deskbook (ABA, 4th Ed. 2010), p. 131 (fig. 1 – Design-Build Structures).

115 Id., at 96.

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Endnotes continued

116 See, Bruner & O'Connor on Construction Law §§6:34 – 6:36.

117 See, e.g., 2 Bruner & O'Connor on Construction Law §§6:37, 6:42, 6:50; See also, K. Kester, J. Heisse, J. Schenck, The Design-Build Deskbook (ABA, 4th Ed. 2010), regarding licensing and state by state issues.

118 See, e.g., 2 Bruner & O'Connor on Construction Law §§6:15, 6:22; U.S Dept. of Transportation, Federal Hwy Administration, Design-Build Effectiveness Study (Jan. 2006) (www.fhwa.dot.gov/reports/design-build).

119 See, K. Kester, J. Heisse, J. Schenck, The Design-Build Deskbook (ABA, 4th Ed. 2010), supra, at 138-139.

120 See, e.g., ConsensusDOCS 471 (design-build performance bond excluding design services) and ConsensusDOCS 473 (design-build payment bond excluding design services).

121 See, K. Kester, J. Heisse, J. Schenck, The Design-Build Deskbook (ABA, 4th Ed. 2010), supra, at 139-140; Special thanks also to Brian Cooper, Managing Director, Gallagher Construction Services, San Francisco and Keith Newell, Sr. V.P., of Heffernan Insurance Brokers in Los Angeles, for their valuable insights.

122 Id.

123 Id.

124 See, Id.

125 See, 1-3 Fifty State Construction Lien & Bond Law (R. Cushman, S. Butler, 2d ed. Aspen Law & Business 2000).

126 See, *State ex rel. American Subcontractors Ass'n, Inc. v. Ohio State University*, 940 N.E.2d 984 (Ohio 2011).

127 See, generally, 2 Bruner & O'Connor on Construction Law §§6:18.10 – 6:18.90; R. Mauck, W. Lichtig, D. Christian and J. Darrington, *Integrated Project Delivery: Different Outcomes, Different Rules*, (2009 Victor O. Schinnerer & Company, Inc.), an unpublished paper originally presented at the McDonough Holland & Allen PC 48th Annual Meeting of Invited Attorneys, and presented at the 26th Annual Legal Retreat, 2009 Associated General Contractors of California – Legal Advisory Committee.

128 R. Mauck, W. Lichtig, D. Christian and J. Darrington, *Integrated Project Delivery: Different Outcomes, Different Rules*, supra note 107, at 5.

129 Id.

130 Id., at 14-15.

131 See, generally, 2 Bruner & O'Connor on Construction Law §§6:18.10 – 6:18.90; R. Mauck, W. Lichtig, D. Christian and J. Darrington, *Integrated Project Delivery*, supra note 107; D. MacNeel, *The Truth About Lean Construction*, Constructor Magazine (2011, July/Aug) (AGC of America, McGraw Hill Construction).

132 See, e.g., AIA B195, A195 and A295; C195 and exhibits; B. Cooper, Managing Director, Gallagher Construction Services, San Francisco, *Insuring & Bonding Projects Using Integrated Project Delivery*, a presentation for AGC California in 2009.

133 See, 2 Bruner & O'Connor on Construction Law §6:18.45.

134 The authors thank the many persons who shared their experiences in this regard.

135 See, e.g., B. Cooper, *Insuring & Bonding Projects Using Integrated Project Delivery*, supra, at note 112; Some insurers are studying the IPD risks. A new policy from Catlin Insurance Company called CP3 attempts to address the IPD method as respects the professional liability exposure of the IPD team.

136 B. Cooper, *Insuring & Bonding Projects Using Integrated Project Delivery*, supra, note 112.

137 Id.

138 Id.

139 Id.