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A Periodic Legal Update from the Construction & Surety Law Practice Group

January 28, 2013

Seeing the Forest AND the Trees

Handling Contract Surety Bond Claims with an Eye on the Big Picture

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A Grim Tale

Once upon a time, Best General Contracting, Inc. hired Able Electric Services Co. to perform the $900,000 electrical scope of work on a library project for a local college. Having not worked with Able before, and in light of the value of the electrical scope, Best required Able to obtain subcontractor performance & payment bonds for Best's benefit, agreeing, of course, to reimburse Able for the $13,500 bond premium.

As fate would have it, the library project proved one too many for the not-so-able Able, who ran into cash flow problems, sought bankruptcy protection and abandoned the project. Best immediately fired off a notice of default letter to Superior Surety and hoped that the claims handling process would match previous, positive experiences with subcontractor sureties and culminate in a quick, fairy-tale resolution to this project setback.

To Best's surprise, it would not. Superior's claim investigation continued for weeks, subjecting Best to a barrage of complaints from the owner about the project's stalled status. Finally, six weeks after Able's default, Superior identified a potential replacement sub, Reliable Electrical Co., but refused to make a formal tender. Instead, it suggested that Best hire Reliable directly, since, as Superior asserted, the remaining subcontract balance would be sufficient to cover all electrical completion costs, obviating the need for Superior to remain involved. Best had its

doubts, but when Superior formally exercised the "pay obligee" option under the applicable subcontract performance bond, there wasn't much Best could do other than hire Reliable and reserve its rights against Superior. Unfortunately for Best, its worst fears were realized, as the remaining electrical scope exceeded the subcontract balance by $500,000, all of which Best financed, with great difficulty, out-of-pocket.

After completing the project, Best demanded payment of the $500,000 delta from Superior, who rejected the claim on a variety of grounds, none of which Best believed to be legitimate. Lawyers were hired. A lawsuit was filed. Discovery was exchanged, depositions were taken, motions were heard. Finally, on mediation day, Superior agreed to pay the principal amount of the claim, with Best agreeing to give up its interest and attorneys' fees claims in order to resolve the litigation and move on.

It's two months later. Best has been awarded another big project, and now must make some key decisions about managing the risk of subcontract non-performance by certain trades. This time around, Best has educated itself on alternative performance guarantee vehicles, including subcontractor default insurance and irrevocable letters of credit. In short, Best has options, and based on its experience with Superior, all options are on the table.

The Moral of the Story

Construction surety bond claims are not handled in a vacuum. Both the process and the outcome of claims handling can have ripple effects in the broader risk management marketplace. Bad experiences can leave lasting impressions on obligees that might influence their future behavior, including whether to seek contract surety bonds at all. Focusing solely on the claim at hand could result in missing the forest for the trees.

Obligee satisfaction with contract surety bonds was the topic of an hour-long presentation at last week's Mid-Winter Program sponsored by the ABA's Tort Trial & Insurance Section, Fidelity and Surety Law Committee, in New York City. Ms. Lynn Schubert, President of the Surety & Fidelity Association of America, spoke on these issues with the help of pre-recorded video appearances by several bond obligees who had experiences similar to the fictional one Best General Contracting had in our fable above. Like Best, the obligees in the video appearances developed the perception that some surety companies too readily side with their principals in handling and disputing bond claims. Also like Best, these obligees came to understand that contract surety bonds are not the only game in town when it comes to managing downstream performance risk on construction projects.

Keeping an Eye on The Big Picture

Like consumers of any other product, potential purchasers of contract surety bonds must believe that they will receive value from the bonds they purchase before plunking down the standard 1-2% premium to obtain them. How can surety companies and the attorneys who represent them

(yours truly included) deliver that value? In Ms. Schubert's words, by "doing the right thing." In practical terms, that means the following:

- **Being proactive.** For example, when a performance bond claim is made, offer to go to the obligee's office, figure out the details surrounding the default and work on a project/scope recovery plan together.

- **Being timely.** While contract defaults are inherently disruptive, sureties can minimize the impact by showing a sense of urgency in the claims handling process and working to get the project/scope back-on-track with as little time lost as possible.

- **Being professional.** It's understandable to be hard on the facts surrounding a contract default, but it rarely makes sense to be hard on the people involved.

- **Being accessible.** Effective communication between and among all parties affected by a contract default is key. Sureties can facilitate effective communication by providing obligees with the contact information for the responsible claims manager and/or legal representative and by responding timely when contacted.

Contract surety bonds are not the only game in town. It makes sound business sense to treat performance bond obligees as potential customers in the claims handling process.

- **Being accountable.** That means approving valid claims timely, and then turning to salvage remedies against the principal to mitigate loss.

Most obligees understand that a surety's investigation of a contract default must be probing and thorough (and for those obligees who may be unfamiliar with the claims process, I recommend this concise brochure published by AGC as a primer). Indeed, the obligees who appeared by video during Ms. Schubert's presentation last week acknowledged that many of their respective experiences with surety companies had been excellent.

When disagreements arise, however, the process still matters, and as we all know, one bad apple can spoil the entire barrel. To remain competitive in the contract performance risk management marketplace, surety companies and the lawyers who represent them should remain mindful of the big picture *every* time a contract default is investigated. The claim under consideration is not just that of a bond obligee, but also that of a potential surety bond customer, and poor treatment of that customer isn't good for business.

This article is adapted from a post originally published on Matt Bouchard's blog, "N.C. Construction Law, Policy & News," which can be found at www.nc-construction-law.com.

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