Surviving the Fight

6 tips for protecting your company when it comes to bond claims

BY BEN WILLIAMS

Former heavyweight boxing champion Mike Tyson famously said, "Everybody has a plan until they get punched in the face." This is as true in construction as it is in boxing. Even the best contractors can find themselves in the middle of disputes. Occasionally, these disputes escalate, and the contractor is presented with a bond claim. Depending on the size of the claim and the strength of the company, these claims can put contractors on the ropes and even knock them out of business. So, what can contractors do to protect themselves?

Most projects involve either performance bond claims or payment bond claims. Generally speaking, a performance bond guarantees that the contractor will perform the obligations spelled out in the contract, while a payment bond guarantees that the contractor will pay subcontractors and suppliers. Each contract and bond form is a little different, but, generally, four events need to occur before the bond company will act on a bond claim. These include:

1. The contractor has to be in default (breach of contract).
   a. The obligee (owner or upstream contractor) has to declare the contractor in default. Don't make the mistake of defaulting yourself. Contractors and bond companies have pointed out that claims cannot be made because they haven't been defaulted. This will immediately prompt a default letter.
2. The obligee must have performed its obligations under the contract.
3. The obligee must terminate the principle's right to proceed.

Once these requirements are met, it is the bond company's responsibility to investigate the claim to see if it is valid. If the default is found to be accurate, the bond company will have four options to pursue:

1. *Financing the contractor*—With this option, the bond company provides financial assistance to the contractor to complete the job. All financial assistance from the bond company adds to the loss, and the bond company will expect reimbursement from the contractor and indemnitors. Typically, in a financing situation, the surety will require the contractor to reaffirm a pledge of personal assets and/or set up joint checking accounts to handle contract proceeds.
2. *Takeover*—This option allows the bond company to step into the contractor's position on the contract and complete the work according to the contract.

Bond companies would choose this route if the job is closer to completion. However, because it can open the bond company up to additional liability, this option is rarely used.

3. *Tender new contractor*—The bond company chooses a new contractor to finish the job. The bond company will negotiate the price and terms of the contract, and then submit to the obligee for approval. One reason a bond company may take this option is if the contractor disputes the default. The bond company can tender a new contractor and later dispute their liability with the obligee.
4. *Obligee completion*—Often referred to as owner completion or "do nothing" option. This is an option if hazardous waste is involved, the surety believes the contractor has a valid defense, the obligee will not have damages because the remaining contract proceeds will cover the cost of completion or the cost to complete will be more than the penal sum of the bond.

Regardless of the claim, surety bonds require indemnification, which means that the bond company will come back to the construction company and owners looking to be reimbursed for any loss. Therefore, none of these options are good for the construction company. Check out the following tips to reduce the pain and ensure your company gets off the mat.

1. NEGOTIATE WITH THE CLAIMANT

By the time a bond claim is submitted, the relationship has suffered some strain. It is better if the two parties can reach an agreement. Keep in mind that once a bond company gets involved, you will be working with the bond company's claims people and attorneys, and not the underwriters and agents that you have relationships with previously. These are two different groups of people with different goals in mind. Along those lines, do not default yourself.

2. DON'T OFFSET BONDED & UNBONDED OBLIGATIONS

Many contractors choose to work with the same reputable subcontractors and suppliers on multiple projects. However, not all projects are equal. Contractors can get into trouble when they withhold payment on a bonded job because of nonperformance on another job. Even though it sounds unfair, a subcontractor or supplier will have a valid bond claim if the company has not paid them for work on a bonded job, even if they have not performed their obligations with your company or other projects.

3. READ THE CONTRACT

This sounds simple, but it is the most important part of the process. Bond companies guarantee the contract and must use its terms and conditions, along with the bond forms, to decide if the contractor is in default. Make sure that you have met all necessary conditions to the owner, subcontractor or supplier. Then, it's time to decide whether there is a valid bond claim. In many cases, subcontractors and suppliers use the bond as leverage to collect payment. If this is the case, make sure you communicate that to your bond company early in the process.

4. KEEP AN EYE ON THE TIMELINE

Once you receive notice of a bond claim, check to see if it was filed promptly and properly. Most bond forms require written notice of a claim within a certain period of time. State and federal laws, along with case law, tend to vary, but improper paperwork could cause any claim to be invalidated. Make sure to know the laws and local regulations for where you operate.

5. DON'T FORGET TO DOCUMENT

You must keep good records to survive a serious bond claim. Emails, photos, checks, pay app and other records become valuable information. Make sure you have systems in place so that you can document and easily retrieve this information.

6. CHECK YOUR INDEMNITY

If there is a valid claim and the bond company has to cure the default, it will eventually seek reimbursement from the construction company and potentially owners or other indemnitors. Refer to your general indemnity agreement—the document you signed when you started working with your bond company. Unfortunately, many contractors do not read these until there is a problem. This document will outline all of your responsibilities and requirements to the bond company, including notice requirements. Personal indemnity is of great importance to contractors. Someone will have signed on behalf of the company, but check to see what other indemnitors have signed as well. Usually, a signature under a person's name will mean they are personally indemnifying, meaning that personal assets are at stake. Be on the lookout for a "Capital Retention Agreement." Many contractors sign this believing they have no personal indemnity. In reality, the indemnity kicks in when the company's financial strength drops, for instance, during a bond claim. Some bond companies may be willing to trade personal indemnity for your willingness to stick around and see that the bonded obligations are finished. Then again, some will not, as they expect this already and it is in the indemnitors' best interests to minimize any losses.

Despite best efforts, bond claims are always a fight. Even the best contractors typically walk away a little bruised. However, with the right knowledge and experts in your corner, you and your company can survive to fight another day. **CBO**

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