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AN OFFICIAL PUBLICATION OF THE NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

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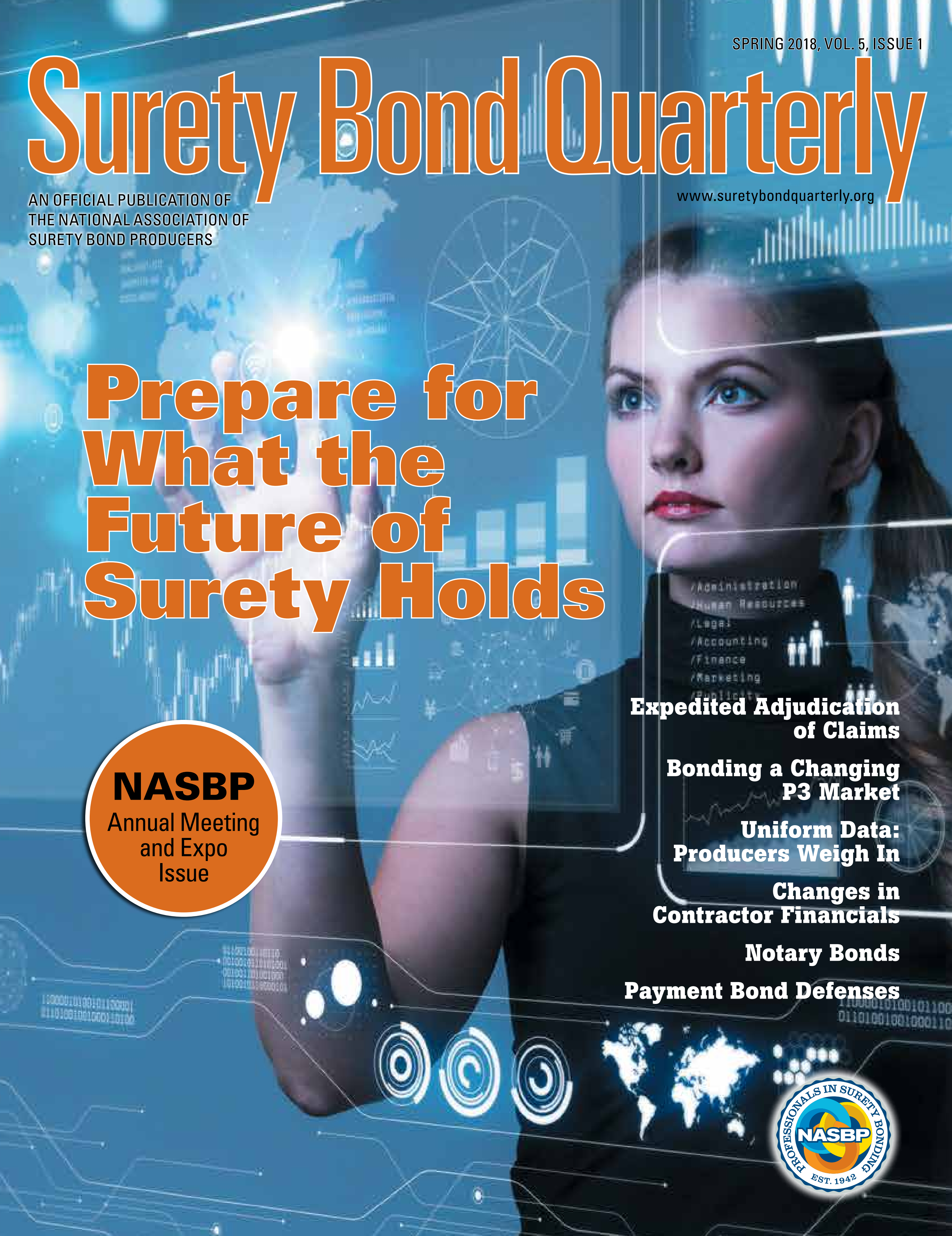

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Expedited Adjudication of Claims

Bonding a Changing P3 Market

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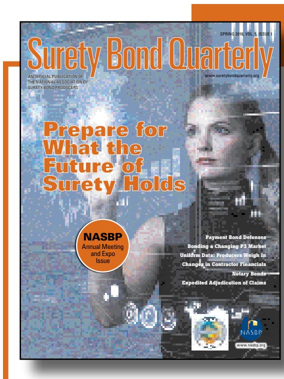

ON THE COVER

SPRING 2018

What does the future hold? From the ins and outs of P3 projects to speedier adjudication of disputes to the arrival of data standards, the spring issue of *Surety Bond Quarterly* looks at some of the financial, legal, and regulatory issues that are reshaping the industry.

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April 29-May 2, 2018
Scottsdale, AZ

LEGISLATIVE FLY-IN
June 5-6, 2018
Washington, DC

SUMMER SURETY SCHOOL—Levels I & II
July 29-August 3, 2018
West Palm Beach, FL

REGIONS 1, 2 & 3 MEETING
September 12-14, 2018
Coeur D'Alene, ID

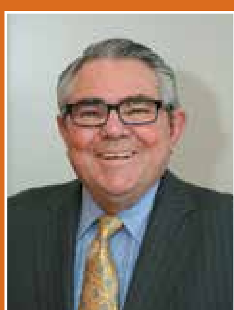
REGIONS 8, 9, 10 & 11 MEETING
September 16-18, 2018
Charleston, SC

LEADERSHIP WORKSHOP
September 19, 2018
Charleston, SC

SALES WORKSHOP
October 2-3, 2018
New Orleans, LA

REGIONS 4, 5, 6 & 7 MEETING
October 3-5, 2018
New Orleans, LA

2017–2018 Executive Committee



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The three most important things in surety are:

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& Relationships

Ensure Success: Innovative Ways to Address Disputes and Claims

Disputes and claims are a reality of the construction landscape and, in turn, that of the surety guaranteeing contractor performance. As the procurement and financing environments surrounding construction contracting are changing, so too are the methods and means for handling construction and surety claims. Efforts to design and to apply systems to mitigate and to address construction disputes early in time are being applied with greater frequency in both traditional and alternative project delivery modes. The advent of public private partnerships to deliver badly needed vertical and horizontal infrastructure is pushing stakeholders to consider dispute processes beyond the norm, especially adoption of systems to deliver real time, expedited dispute resolution.

This issue of the *Surety Bond Quarterly* springs into the subject of the innovative ways that disputes and claims are being handled today. Attorney Todd Regan, a partner in the law firm of Robinson Cole, relates how some sureties are accelerating resolution of performance bond claims through expedited dispute adjudication methods defined in performance bonds for public private partnership projects. Likewise, attorneys Frank Rapoport and Jerry Brodsky, partners in the law firm of Peckar & Abramson, illuminate the changing public private partnership market in the United States, paying particular attention to the value of bonding and of dispute review boards in avoiding and mitigating disputes and claims.

Claims also are treated as important subjects in two other articles in this issue. Attorneys Lauren Rankins, Erica Del Aguila, and Aniuska Rovaina, associates with the law firm of Watt, Tieder, Hoffar & Fitzgerald, provide a succinct primer on the defenses that sureties have to payment bond claims. On the commercial surety front, attorneys Jeffrey Frank and Omar Harb, shareholders in the law firm of Alber Frank, delve into the intricacies of underwriting notary bonds, including particular claims issues, such as notice and proper claimants associated with such bonds.

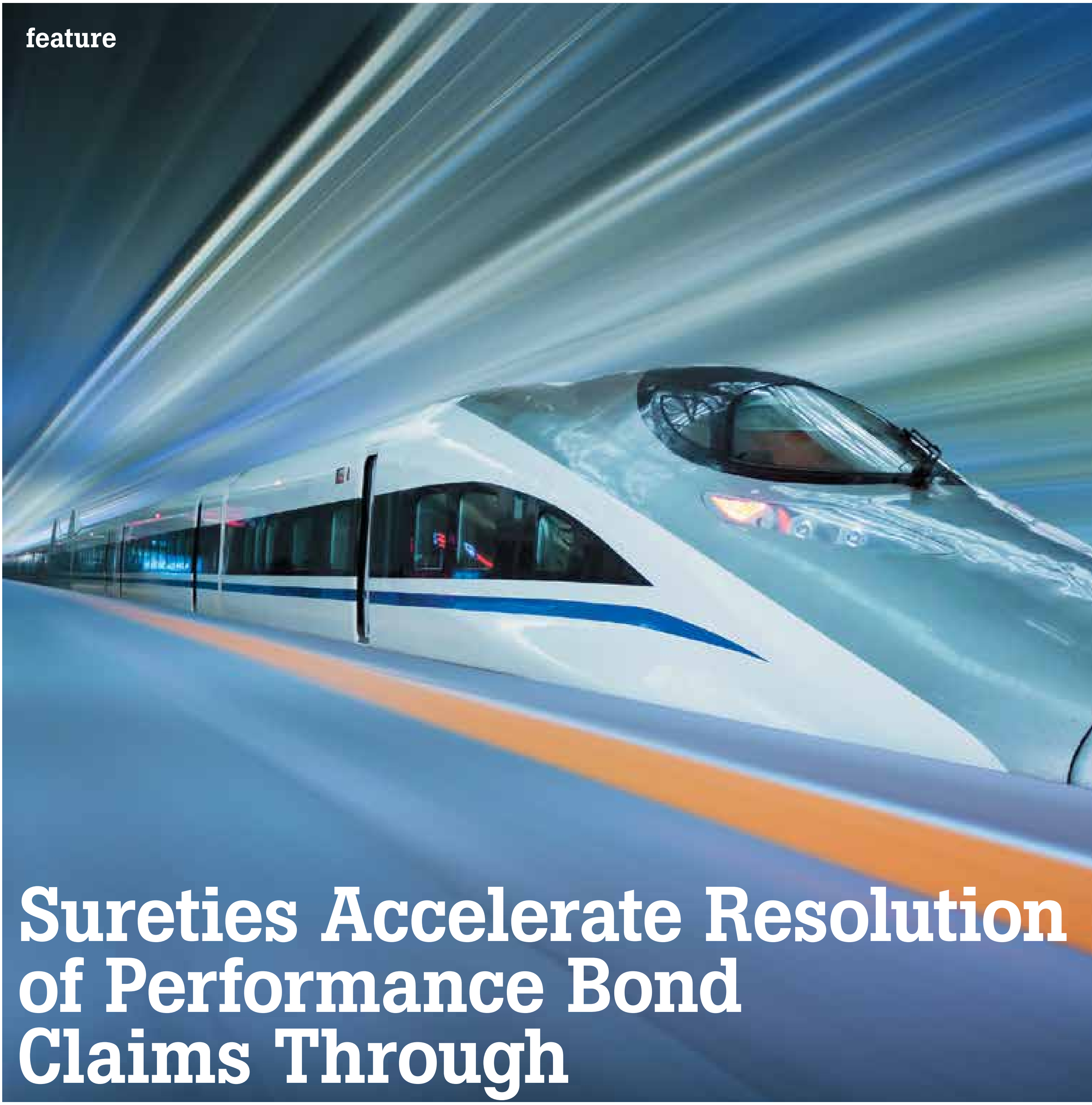
Other articles in this issue focus on success and innovation in other surety industry endeavors, namely the dramatic, beneficial impact that uniform data standards for surety bonds will engender and the efforts of the surety industry in supporting research toward effective therapies for the treatment of post traumatic stress for military veterans and first responders.

Clearly, innovation and success may come in many forms. This issue demonstrates that admirably.

Warmest regards,

Mark H. McCallum
NASBP CEO

feature



Sureties Accelerate Resolution of Performance Bond Claims Through Expedited Dispute Adjudication

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BY TODD R. REGAN

DELAYS CAN BE PARTICULARLY COSTLY ON P3 PROJECTS, BECAUSE CONCESSIONAIRES GENERALLY RAISE FUNDING FROM INVESTORS AND LENDERS BASED ON A FUTURE REVENUE STREAM, OFTEN REFERRED TO AS THE CONCESSION (FOR EXAMPLE, FUTURE TOLL PAYMENTS OR AVAILABILITY PAYMENTS FROM THE PUBLIC OWNER).

CRITICS OF THE use of surety bonds often point to perceived delays in the resolution of performance bond claims as a basis for turning to alternate forms of performance guarantees, such a letter of credit (LOC) or subcontractor default insurance (SDI). In order to address these concerns and to meet the particular needs of public private partnership (P3) projects, some sureties offer performance bonds that provide for expedited adjudication of disputed performance bond claims. In some instances, these bonds may also provide immediate, on-demand payments to the obligee upon the declaration of default. These bonds seek to minimize potential project delays and the associated liquidated damages and other costs that could accrue during the surety's investigation of a contractor default, while at the same time maintaining the essential characteristics of a performance bond.

The Needs of P3 Projects

P3 projects have traditionally relied on LOCs and the associated liquidity provided rather than using surety bonds to secure contractor performance. P3 projects allow government bodies to tap into private sector resources and ingenuity to fund, design, construction, operate, and maintain facilities that benefit the public and that would otherwise have been procured under the typical design-bid-build project delivery system. A P3 project will typically involve an agreement between a public owner and a private entity, often known as the concessionaire. The concessionaire in turn will have agreements with lenders and equity investors to finance the project, as well as a separate agreement with a design-builder for the construction of the project.

Delays can be particularly costly on P3 projects, because concessionaires generally raise funding from investors and lenders based on a future revenue stream, often referred to as the concession (for example, future toll payments or availability payments from the public owner). Lenders and investors have favored the use of LOCs over surety bonds in order to provide liquidity to hedge against liquidated damages and lost revenues resulting from project delays following a default by the design-build contractor.

Unlike the AIA A312 Performance Bond, which requires the obligee to provide the surety with a written declaration of default and provides the surety with an opportunity to investigate and with various performance options, a LOC is an on-demand instrument that entitles the owner to an immediate cash payment simply by alleging a default. Thus, a LOC satisfies the need for an immediate cash infusion needed to cover debt service obligations and immediate project costs following a contractor default.

The Benefits of Bonding P3 Projects

The benefits of bonding 100 percent of the design-build contract value are well established. Sureties bring their industry experience and deep knowledge of a contractor's complete financial background to bear in the underwriting process. This permits sureties to conduct a far more reliable prequalification of the proposed design-build contractor than could otherwise be conducted by the public owner or concessionaire alone. Furthermore, sureties often work behind the scenes to fortify a struggling contractor, so that a potential default across multiple projects is avoided. In this respect, having bonds in place can reduce the likelihood of contractor default in the first place. In addition, sureties bring vast experience in investigating and remedying defaults.

Yet, despite the surety industry's well-established track record of successfully providing performance security for large, complex projects, performance bonds are not universally required on P3 projects. Indeed, of the 33 states and one territory that have enabling laws permitting the use of P3s for certain types of projects, only 26 of those jurisdictions require bonds. Instead, some jurisdictions call for performance security packages, which may include a combination of a LOC, parent company guaranties, retainage, and SDI.

The Surety Solution for P3 Projects

Against this background, sureties have developed performance bonds that are designed to satisfy the needs of P3 projects. One such example is Zurich's Public-Private Partnership Performance Bond, which is exclusively offered for use in Canada, where P3 projects have historically been more common. The Zurich P3 Bond, which can be tailored for specific projects, features both a liquidity component and an accelerated dispute resolution feature. Typically, when written for P3 projects, these bonds will have a lower penal sum than standard performance bonds, usually in the range of 50 percent of the contract sum. In order to provide liquidity, the bonds have an "on-demand" feature that requires the surety to make an immediate payment to the obligee of up to 5 percent of the penal sum upon the declaration of contract default, in order to cover liquidated damages. In addition, in order to avoid project delays, the bond contains a fast-track dispute resolution procedure. All disputes concerning the validity of the declaration of the contractor default are submitted to a pre-selected adjudicator for expedited resolution.

Another product that has been offered for use on P3 projects in the U.S. is Travelers' Expedited Dispute Resolution Performance Bond (EDR Bond). Unlike other bonds developed for the P3 market, the EDR Bond does not provide an on-demand payment or liquidity component. Instead, in the event that a dispute arises concerning a performance bond claim, the surety or the obligee has the right to submit the dispute to JAMS for expedited resolution before a pre-selected adjudicator. The adjudicator is then tasked with answering three questions: (1) Is the principal in default of its obligations? (2) Has the obligee complied in all material respects with its obligations? (3) Is the surety liable to perform under the bond?

All parties are required to continue to perform on the project pending resolution of the dispute, which must be issued no more than 43 days from the referral of the dispute for resolution. The adjudicator's decision is binding on the parties until the project is completed, but the parties reserve the right to later appeal the adjudicator's decision to a court of competent jurisdiction.

Notably, the EDR Bond provides coverage up to the full contract value for the design and construction work to be performed under the P3 agreement and expressly provides coverage for liquidated damages and the contractor's warranty obligations.

The EDR bond was accepted for the first time as part of the performance security package for the $899 million Pennsylvania Rapid Bridge Replacement Project, the largest road project in the state's history. This high-profile project involved the replacement of 558 structurally deficient bridges across the state over a three-year period, procured through a design-build-finance-maintain P3 agreement between PennDOT and Plenary Walsh Keystone Partners as the concessionaire/developer.

Quite significantly, the $899 million EDR Bond posted by Travelers, along with Zurich and Chubb as co-sureties, was the first performance bond ever to receive credit from Standard & Poor's as liquidity support equivalent to a 10 percent LOC, per S&P's criteria in establishing Construction Phase Investment ratings.

Not a One-Size-Fits-All Solution

Although performance bonds requiring expedited adjudication of disputed claims and providing on-demand payments may meet the needs of certain projects, they are not a one-size-fits-all solution, nor are they likely to replace the use of the AIA A312 Performance Bond on many projects. As noted above, the A312 Performance Bond provides the surety with important rights and defenses, including the right to receive a written notice of intention to declare a contractor default from the obligee, the right to a pre-default conference, and an opportunity to investigate the circumstances surrounding the declaration of default, as well as various performance options. These rights protect both the surety as well as the contractor-principal, in the event that the contractor disputes the grounds for termination.

Although accelerated adjudication bonds do provide the surety with the option to challenge the validity of the contractor default before an adjudicator, the expedited nature of the proceedings may not provide the surety with sufficient time to fully investigate the claim. Furthermore, sureties may be reluctant in certain instances to submit their defenses to an arbitrator, who may be less inclined to strictly enforce a surety's legal defenses or to dismiss a claim in a summary manner. However, regardless of the form of the bond used, there can be no question that a timely and efficient investigation of a performance bond claim by the surety is in the best interests of all project players in order to minimize potential delays to the project.

Todd R. Regan, a partner with Robinson + Cole's Construction and Surety Practice Group, represents the full range of construction and surety industry stakeholders in claims involving project delays and inefficiencies, defective design and construction, unfair trade practices and bad faith, and mechanic's liens and bond claims. He also counsels clients in the negotiation of complex construction agreements. Regan serves on the NASBP Attorney Advisory Council. He can be reached at tregan@rc.com or 860.275.8293.


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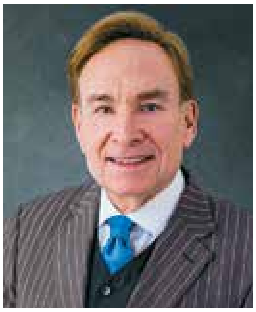
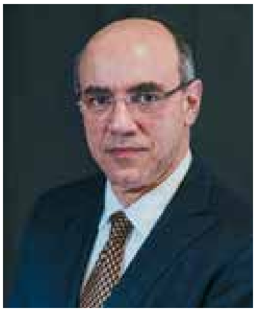
Bonding the Rapidly Growing and Changing P3 MARKET in the U.S.

BY FRANK M. RAPOPORT AND JERRY P. BRODSKY

SUBCONTRACTORS AND SUPPLIERS RELY ON THE PAYMENT BOND IN CASE THE GENERAL CONTRACTOR DOES NOT OR CANNOT PAY THEM. THEY CANNOT LIEN PUBLIC PROPERTY FOR PAYMENT, SO THE PAYMENT BOND PROVIDES THEM THEIR ONLY PROTECTION.

PUBLIC-PRIVATE PARTNERSHIP (P3) projects have finally emerged in the U.S. infrastructure market. Contractors and their sureties must be poised and committed to profile their willingness and capabilities to embrace this new model of project delivery. Those minimizing this inevitable shift will be left out of upcoming deal flow from mayors, governors, and county officials. Asset classes moving rapidly to the P3 market include K-12 schools, higher institution dorms and life science centers, municipal and state buildings, water and wastewater, transit and mixed-use transportation oriented development. Witness pending and closed deals involving Long Beach Civic Center; La Guardia Central terminal and parking structure; West Chester, Phoenix, Denver, and San Juan Airports; Howard County and Long Beach Courthouses, and a slew of road and bridge deals including I-595, I-66, Presidio Parkway, Ohio River Bridges, and Goethals Bridge. All of these and other projects represent $50 billion in P3 activity.

This article will explore the benefits of P3 projects and why P3 projects will increase dramatically. More specifically, this article will address the role of surety bonds on P3 projects, new bond forms attendant to P3 projects, and how to maneuver the risk issues relevant to P3 projects.

Why P3 is Now Mainstream

Unsustainable state and municipal debt levels have brought P3 projects to the forefront. The P3 technical innovation, quality construction, on-time delivery, and operational benefits have created its growing acceptance and are transforming how public infrastructure is delivered. Recently, we have seen evidence that the partnerships between public agencies and private enterprise are critical to a state's planned infrastructure development. So much so that a governor vetoed a bill he believed put P3 projects in jeopardy.

In the summer of 2016, Colorado Governor John Hickenlooper vetoed SB14-197, an anti-P3 law, and stated, "We firmly believe that government should always strive to be transparent and accountable." He added in his veto message, "Unfortunately, SB 14-197 is not just a transparency bill; it also inappropriately constrains the business terms of future P3 agreements." The governor instead signed an executive order that will improve transparency, accountability, and openness; while avoiding aspects of the proposed bill that would have discouraged private sector participation in future P3 agreements. The leadership demonstrated by Governor Hickenlooper, through his veto, and more importantly, by his executive order, showed a clear path to achieve what must be undertaken in order to balance the public interest while allowing the innovation and quality delivery that the private sector can bring. Governors rarely veto bills so this action is noteworthy as a precursor of the further emergence of P3 projects.

Key leaders across the nation are realizing that P3 opportunities encourage private sector investment in their states and provide long-term solutions for delivering core infrastructure and creating new economic development opportunities.

These government officials are realizing that P3 projects help protect taxpayers through complimentary incentives. P3 projects gain skin in the game of private financing with financiers who risk their money to get the project off the ground. P3 projects also account for the full cost of operating and maintaining the project over many decades, not just the initial construction. Additionally, P3 projects give the government more control, not less, by holding those private partners liable for problems like delays, cost overruns, and deferred maintenance.

P3 projects are very different from the way most public infrastructure projects are built today. In most cases, today's projects are designed by the government and awarded to the proverbial lowest bidder. The lowest bidder has no say or motivation suggesting a better innovative solution and plays no role in how quickly the asset falls into disrepair. Indeed, there is little or no attention paid to what the project will cost the taxpayer over its useful life, much less where its maintenance funding will come from. And there are few protections for the taxpayer when costs rise, delays creep or political infighting prevents spending money to cure maintenance. The results leads to public buildings that aren't maintained, roads with too many potholes, and water systems that leak and waste water, as the pipes are over 100 years old. P3 projects offer a better way:

ON TIME, ON BUDGET: Payments to the private sector team under the

P3 model typically occur only when a project is completed. Therefore, the private partner is highly motivated to complete a project on time and on budget so that it can begin revenue generation or reduce the accrual of its debt financing. In the very few instances where a P3 private partner failed to deliver an asset as stipulated, the taxpayer was not penalized and the private partner absorbed the financial loss.

PROPER MAINTENANCE: P3 private partners agree to maintain (not own) through a concession the public's assets to specified requirements through contractual agreement, often 30-50 years. If these requirements are not met, the private partner is not paid or incurs penalty payments. An added bonus is that P3 projects with a pre-negotiated fixed maintenance component may help the public sector avoid inflation-related pricing that would increase the cost of maintenance over the years.

INNOVATION & PERFORMANCE: Under the P3 model, the private partner is accountable for all phases of project design, construction, and maintenance; and long-term profitability is dependent on operational efficiency. Therefore, private partners are incentivized to deliver an asset that is effective, efficient, and sustainable for several decades. There's far less chance that a P3-built and-managed asset will have design flaws, financial failures, or technology obsolescence. Innovative ideas might include more redundant mechanical systems in a vertical structure or advanced monitoring systems on roads.

Critics say that privately financed debt and equity is more expensive than public, or municipal, debt. This is a false comparison. Public debt is cheap because governments have the taxing authority to pay it back. Therefore, the taxpayer guarantees it—and pays for all the performance problems, too. Projects financed by cheap municipal debt lack the built-in P3 incentives to budget for the asset's maintenance over the long run.

Currently, 35 states, the District of Columbia, and Puerto Rico have some form of P3 legislation, although most are limited to transportation. Eleven allow P3s for vertical infrastructure, such as courthouses. Most of these laws require performance and payment bonds, in addition to letters-of credit.

The Value of Bonding and Dispute Review Boards on P3 Projects

Attending any construction project are differences/disputes between or among the parties, which are in need of resolution to keep the project momentum. Just as the public is protected due to the risk shifting to the P3 entity, the down-stream P3 team members need protection. Therefore, P3 team members must have access to remedies that encourage them to keep working and get paid while a difference or dispute is pending.

The performance bond is issued only to those contractors that, in the surety's estimation, can perform the

THE CONCESSIONAIRE AND DESIGN-BUILD TEAM ON A P3 PROJECT

When the concessionaire is the one that has the contract with the public owner, the concessionaire is the statutory "contractor."

This means that the DB contractor is a "sub" under the statute, and if we follow the statutory definitions down the food chain, an entire tier of subcontractors and suppliers that usually have statutory bond protection do not.

work and pay all the subcontractors, suppliers, and workers on the job. The surety's prequalification aims to prevent default. By issuing a bond, the surety provides the public contracting entity with assurance from an independent third party, backed by the surety's own funds, that the contractor is capable of performing the construction contract.

Subcontractors and suppliers rely on the payment bond in case the general contractor does not or cannot pay them. They cannot lien public property for payment, so the payment bond provides them their only protection. Bonding supports economic empowerment, sustainability, and job creation for contractors and subcontractors.

In the event of a default, the surety can step in to complete the contract or hire a new contractor to complete the project, saving the taxpayers from extra costs to re-let the project and extra completion costs. Sureties also can extend the contractor credit during the project to help avoid a default in the first place. The performance bond assures the public owner that the construction contract will be completed. New forms encourage prompt resolution of disputes, which is critical in P3 even more so than in the traditional design-bid-build model; stopping work is not a viable option. The expedited dispute resolution bond form was used on the Pennsylvania Rapid Bridge Replacement Project and proposed on several others. This bond form mitigates failed completion risk by resolving, within a definitive and compressed time frame, the surety's completion obligation in the event of a design-build joint venture (DBJV) default. It does not mitigate delayed performance risk, which requires liquidity.

On Canadian P3 projects, sureties have issued a hybrid liquidity bond form. This bond form includes a liquidity component that provides a remedy if the DBJV fails to timely make liquidated damages (LD) payments and a traditional completion obligation if the obligee elects to request performance after a partial payment under the liquidity component. This liquidity bond form has been proposed on U.S. P3 projects but has yet to be issued for a U.S. P3 project. Watch for the surety industry to announce and further refine these new bond forms.

The expedited dispute resolution bond form normally uses a third-party mediation group, such as JAMS, to help resolve disputes. Dispute review boards (DRBs) are also contracted for among the parties at the inception of the project.

The DRB model consists of three members appointed at the beginning of a project. Some users on smaller projects are using dispute resolution advisors who function as single-person DRBs.

DRB members have extensive experience in construction projects and claim-resolution processes and often are selected for particular expertise in the type of project at hand. DRB members are required to be neutral, disclosing potential or actual conflicts of interest and committing to remain neutral and conflicts-free for the duration of the project. The DRB recommends the parties jointly select the three DRB members to ensure confidence in the DRB's expertise and neutrality.

After appointment, the DRB becomes familiar with the project and attends an "all hands" kickoff meeting to meet the players and start establishing a working relationship with the main parties. Thereafter, the DRB is kept abreast of project developments with regular paper updates or access to the project's information-sharing website.

The DRB periodically returns to the project site for meetings with the parties to get project updates, discuss issues or challenges, identify emerging disputes and continue building relationships with the parties. This regular interaction with the parties and monitoring of project events focuses on preventing issues from becoming disputes.

DRB's best practices also recommend that the DRB be available to give the parties advisory opinions. Advisory opinions typically are used for smaller, discrete disputes that the parties would like to resolve by agreement, but with advice from the DRB. The advisory opinion process is usually conducted at regular DRB site visits and is informal.

Other variants reviewed included a model used by the Texas Department of Transportation that may be best described as a "dispute adjudication board." The Texas model operates as a formal arbitration process with a broad scope of review to address project disputes. This board hears disputes and issues written findings of fact, conclusions of law, and decisions. The process and procedures of this board are typically set forth in a separate dispute board agreement appended to the contract. See K. Dettman et al., Dispute Resolution Board Foundation, *Recommended Best Practices for Use of Dispute Review Boards (DRBs) on Public Private Partnership Projects in the U.S. and Canada,* July 21, 2015.

P3 Risk Issues and the DRB Process

In the design-build (DB) phase of a P3 project, the critical participants are the public owner, concessionaire, and the entire DB team, led by the DB contractor.

Two other critical participants during the DB phase include the following:

- OCEI (owner construction engineering and inspection) team— inspectors hired by the *public owner* for quality control and compliance monitoring; and
- CCEI (concessionaire construction engineering and inspection) team—inspectors hired by the *concessionaire* for a similar role.

Once the lenders have put up their money and with the operations and maintenance contractors waiting for their time, the DB team drives the project forward during the riskiest period of the P3 life cycle.

One way to look at risk on a P3 project is to look at the expenditure of the lenders' funds during the project cycle. If we were to plot the expenditure of money over the life cycle of a P3 project, the risk profile would show the lion's share of the money spent (and risk incurred) is during the DB phase.

Given the fact that on most projects the DB contractor's role begins and ends with the DB phase, any contractor working on a P3 project should be aware of the heightened risks faced by the DB team during the P3 cycle.

As counsel for the contractor in the 4-year DB phase of I-595 Florida, we have learned that, in addition to all the traditional risks faced by the DB team on any large project, certain additional risks and issues arise as a result of a P3 project. They include:

- Risks that are created by differences between the funding plan for the project under the P3 model developed by the lenders, concessionaire, and public owner, and the actual design and construction plan that the DB team must perform;
- A heightened risk of having to perform work that is disputed; and
- Risk and uncertainty created when existing statutes that regulate public works are applied on a P3 project.

In the traditional design-bid-build model, the funds for construction are made available to the contractor based on the progress of the works. This is important because proper cash flow is, of course, absolutely vital to every construction project. What happens on many P3 projects is that the financial model, which is prepared and submitted as part of the proposal, is based on milestones that are not well coordinated with the planned progress of construction. This happens largely because the design on which the financial model is based is very preliminary and often significantly different than the actual construction plan.

One of the results of this dislocation is that funding for work performed early in the construction phase is either released significantly before the work is done, which has never been a real problem, or significantly after the work is scheduled to be performed. The latter situation is problematic because subcontractors are unwilling or unable to accept the "pay when paid" risk, and those

NASBP CE BREAKOUT SESSION APRIL 29 AND 30: "JUMP ON THE P3 WAVE: THE VALUE OF BONDING IN THIS RAPIDLY GROWING MARKET"

Be sure your firm is not left out of this rapidly growing and changing market. Gain a better understanding of public private partnerships (P3s) by attending the NASBP continuing education session, titled "Jump on the P3 Wave: The Value of Bonding in this Rapidly Growing Market," held during the NASBP Annual Meeting at The Phoenician Resort in Scottsdale, AZ, April 29 from 1 to 3 p.m. and April 30 from 12:15 p.m. to 2:15 p.m.

Presenters Michele Pavlik of Chubb Surety, Mary Jean Pethick of Zurich Surety, and Frank M. Rapoport of Peckar & Abramson, P.C. will examine surety underwriting of P3s; will outline different types of bonds, terms, and obligees in the P3 space; and will explain the legislative landscape at state and federal levels. They will also review the history, structure, and usage of P3 projects. Plan to join us for this interactive session where the speakers will share examples of P3 projects with which they have been involved.

that are willing account for the risk in their pricing, which, in turn, makes the contractor less competitive. The dislocation creates, to say the least, cash flow management challenges to the DB contractor and financial strain on smaller, lower-tier subcontractors.

This financial strain is compounded by the fact that final payment is invariably tied to acceptance of the work by the concessionaire and public owner, which can result in extended exposure to warranty claims and delays in final payment.

The risk of having to continue performing during the pendency of disputes is by no means unique to P3 projects. What is unique is the heightened risk of having to perform disputed work at risk, which is the result of the "Olympics Mindset"—delay is not an option—among P3 participants. The DB contractor, aided by sound legal advice, quickly figured out that, in order to convince the subcontractors to accept the Olympics Mindset and agree to continue performing notwithstanding pending disputes without a major impact on pricing, there had to be an efficient and effective contemporaneous dispute resolution process.

The project already "came with DRBs" (included in the concession agreement for disputes between the concessionaire and FDOT, with some contractor participation). However, there was no requirement or provision for DRBs for the DB team. So, we added that by providing a DRB for resolution of disputes between the concessionaire and the DB contractor and in key subcontracts. These DRBs were subject to most of the rules and regulations that govern the FDOT DRB, with one major difference: FDOT DRB decisions take months to come down; our DRBs are required (unless the parties agree otherwise) to issue resolution within 20 days after the hearing.

Lessons Learned

The biggest lessons for us have been that P3 projects are subject to different economic and legal forces and must, therefore, be well understood in order to be successfully managed.

Some additional issues facing P3 projects include:

- Contrary to a traditional DB structure, in a P3 arrangement, design could be very nascent when buyout occurs.
- Because of the commitment to working through disputes and the financial toll that it takes, certain mom-and-pop subcontractors may not be suitable to participate in a P3 arrangement. The DB contractor needs to ensure solvency and other financial factors when teaming with subcontractors. This increased risk of working through disputes may be reflected in pricing.
- The concessionaire stands in the shoes of the public entity; the DB contractor needs to ensure easements and verify any pending disputes between the public entity and utility.
- Encroachment onto private land is common. Managing those relationships is imperative when considering the progress of a project.
- Contrary to a traditional scenario, there are more eyes on the DB contractor. Government entities, traditional agencies, lenders, and others all have rights on P3 projects to monitor work. The evaluation of the concessionaire's performance can adversely impact a DB contractor who is otherwise performing.

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feature

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XBRL Exec Explains

How Uniform Data Standards Will Impact Bond Producers and their Interactions with Clients and Sureties

XBRL | US

Campbell Pryde

> "END USERS IN THE SURETY BOND CHAIN, LIKE INDIVIDUAL PRODUCERS, GENERALLY WON'T HAVE TO LEARN ANYTHING NEW."
> — CAMPBELL PRYDE, PRESIDENT & CEO, XBRL US

IN A NASBP *Surety Bond Quarterly* exclusive interview, Campbell Pryde, President and CEO of XBRL US, talked about how he envisions the standardization process will impact producers, their clients, and sureties.

Historically, surety bond producers, contractors, and sureties have used their own systems for recording financial data. Moving data to another party or to a different form required manual reentry. Now NASBP is establishing uniform data standards for surety bonds using eXtensible Business Reporting Language (XBRL) to improve business reporting standards. XBRL improves how financial data is communicated by making it easier to compile and share. Tags identify each piece of financial data for use in XBRL-compatible programs so information moves between organizations rapidly, accurately, and digitally.

SBQ: What will having uniform data standards accomplish?

CP: Data standards enable automation of data collection, processing, and extraction. That automation eliminates the need for manual data entry, thereby improving efficiencies throughout the reporting supply chain. The result is greater accuracy and delivery speed so contractors get more timely access to credit with the confidence sureties are evaluating their financial health using the most current information. Sureties and bond producers benefit from increased efficiency, allowing them to process more data much faster and with greater confidence in its accuracy.

Data formats based on a common underlying data language let all participants use standard tools to create, exchange, and consume surety bond information.

SBQ: How will a data standards system work from a technical standpoint?

CP: Contractors today prepare their financials and work-in-process (WIP) statements using varied methods: spreadsheets or software applications generating reports in PDF or Excel. We are working with several software providers to build XBRL generation modules into the existing tools contractors already use to ensure the contractor cost is brought down to zero. An Excel add-in is now available to help contractors, or their accounting firms, convert WIP reports into XBRL.

SBQ: How hard will it be to learn this new system?

CP: There will be an initial learning curve for all supply chain members. Carriers will need to map their internal systems; contractors and their providers, including accounting firms and software providers, will have to adapt their systems to the new standards. End users in the surety bond chain, like individual producers, generally won't have to learn anything new. After learning the system, the new process will be easier for everyone.

SBQ: How much more efficient will it be for surety bond producers to use these data standards?

CP: Once bond producers have set up their systems to accept XBRL-enabled WIP reports and financials, their operations will be significantly streamlined through the elimination of manual re-keying. The automation through standardization will let bond producers be more responsive to their contractor clients. Standards will ensure they have access to the most current data so they can make more informed decisions, helping end users and contractors alike.

Because carriers will no longer need to key data into their internal systems manually, they'll process data much faster. This will let them respond more quickly to bond requests.

SBQ: How much will data accuracy be improved?

CP: With manual data entry, it's always possible to introduce errors inadvertently when re-keying information, requiring manual error-checking. Automation through data standards will not only reduce the need for labor- and time-intensive manual validation, but also it will enable users to create automated validation/business rules they can employ to check that they have received accurate data. Examples of such rules include ensuring data was entered with the correct sign, or falls within certain boundaries, or does not conflict with other concepts used.

SBQ: The WIP report is being used to pilot test the use of XBRL data input. Why was this report chosen? How representative is it of surety industry work? How is the test going?

CP: The WIP report was chosen because it's considered one of the biggest data collection pain points. WIP reports are processed annually or quarterly and can contain numerous rows of data that must be keyed into the carrier's system. The financial terms used by public companies for U.S. GAAP reporting to the U.S. Securities and Exchange Commission were the basis for the WIP Taxonomy because many WIP elements are the same as U.S. GAAP Taxonomy elements. We then added the terms unique to contractors, such as project-specific revenue and profits.

In the pilot, we've demonstrated how to prepare a standardized WIP report using an Excel add-in tool. The pilot shows how data in the WIP can be automatically extracted into a carrier's system.

Those who need to collect or extract data must perform a one-time mapping of their financial systems to the WIP Taxonomy. The Hartford, a surety that has completed the implementation, estimated the process took around 50 hours, including mapping, testing, and training. Once implementation was complete, they could extract data automatically from individual WIP reports into their system without manual data entry. A process that previously took The Hartford 30 to 60 minutes to complete took only three seconds by extracting data from an XBRL WIP report. This time saving will occur regardless of a report's length.

SBQ: What computer equipment and software will users need?

CP: The XBRL data standard and WIP Taxonomy can be used with any software or computer system.

SBQ: What kind of data is next for XBRL standardization?

CP: Our next goal will be standardizing full financials for contractors, which are also re-keyed downstream. The WIP collection of terms (or taxonomy) can easily be expanded to do this. Automating data collection of financials, in addition to the WIP, will improve efficiencies for all reporting supply chain members.

SBQ: How soon will data standards implementation take effect?

CP: Timing depends on how quickly the industry adopts it. To recognize full efficiencies, we need all sureties, contractors, and bond producers to adopt the standard, with contractors and their vendors producing XBRL data and data users consuming data in XBRL format.

Organizations can help shape the new industry standards by becoming early adopters. Contact XBRL US at *info@xbrl.us* for more information.

Keep an eye out for more articles in future issues of *Surety Bond Quarterly* on how the establishment of data standards will impact bond producers, their clients, and other surety team members.

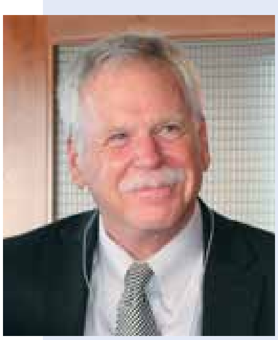
Bond Producers' Perspectives

NASBP BOND PRODUCERS SHARED HOW THEY BELIEVE THEIR AGENCIES AND THE INDUSTRY WILL BE IMPACTED BY UNIFORM DATA STANDARDS

John Bustard

Joshua Etemadi

Nicholas L. Newton



Kevin J. Garrity

SBQ: How will surety automation affect your agency's operations?

John Bustard, ***NASBP Second Vice President and Executive Vice President, King & Neel, Inc. of Honolulu:*** Surety automation has already improved our operations. We were one of the first Erlon users at least a decade ago, and this system has served us well over the years by contributing to better organized underwriting files; more efficient preparation of bid, performance; and payment bonds; and better bond reporting to our surety partners. We look forward to future enhancements.

Joshua Etemadi, ***Assistant Vice President, Construction Bonds, Inc. of Herndon, Virginia:*** Our agency has always attempted to embrace emerging technologies in the industry. Surety automation will speed up our turnaround time, improving our quality of product and allowing us to work on more opportunities.

Nicholas L. Newton, ***President, Newton Bonding of Stillwater, Minnesota:*** Surety automation can significantly impact my agency's operations in a positive manner. Automation of simple and/or complex cases can reduce employee time on tasks, reduce errors, and foster consistency and accuracy across all elements of day-to-day bond agency operations. The end result will be greater efficiencies performed by fewer staff hours and improved accuracy in deliverance of daily tasks. The beauty is this is realized across the full spectrum – from data input to bond reporting/account submission to financial statement analysis.

Kevin J. Garrity, ***Senior Vice President, Rose & Kiernan, Inc. of East Greenbush, New York:*** The surety industry seems to be the last area of the agency business to evolve. Some selective state agencies are adopting electronic bid systems, but agents are largely faced with the need to issue original documents. Agents have begun using automated issuance systems, but the end product most often remains a signed, sealed, and delivered set of documents. NASBP and SFAA have been advocating for and been willing to accommodate change, but until an agreed standard is accepted, this antiquated process could persist.

SBQ: How will surety automation affect the surety industry?

Bustard: It should result in a more efficient underwriting and bond processing world for producers and surety companies, especially young producers and underwriters who are adept and comfortable with the most progressive automation available. Efficiency will be maximized when all stakeholders in the surety process adopt industry standards.

Etemadi: Surety automation will get the surety industry to the way the rest of the business world is operating. As consumers desire quicker answers and faster response times, we have to evolve. Surety automation will allow us to do it intelligently and without diminishing the quality of our underwriting process.

Newton: Surety automation has the potential to revolutionize the time spent and manner conducted of financial statement and WIP analysis by automating the input and analysis portions performed by all sureties. Elimination of re-buying data, electronic transmission of financial statement and WIP, and automatic analysis of financials and WIP will all drastically reduce time spent processing and literally end entry-error mistakes. Surety companies as well as agencies performing these tasks will all benefit greatly.

Garrity: Producers and surety companies continue to work to control what they can. Technology has streamlined the issuance and underwriting process and simplified workflows, allowing us to become more efficient, and eliminated cabinets full of paper files while streamlining billing, tracking, and detail work. Electronic communication and digital files allow us to work remotely and communicate from almost anywhere. Hopefully, as data-based standards continue to evolve, the expectation is forms and processes will also evolve. We must convince those who use our product there is a better way by handling this with new processes like data standards.

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feature

Changes are coming to CONTRACTORS' FINANCIAL STATEMENTS

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BY MATTHEW D. CASH

MANAGEMENT WILL NEED TO BE DILIGENT WHEN DETERMINING WHICH COSTS OR LABOR HOURS SHOULD BE INCLUDED IN THE MEASUREMENT OF PROGRESS.

THE FINANCIAL ACCOUNTING Standards Board's issuance of the new revenue recognition standard, *Revenue from Contracts with Customers*, will fundamentally change accounting and disclosures for construction contractors. The standard is effective for public companies in calendar year 2018 and for private companies in calendar year 2019. This accounting standards update eliminates most of the existing industry-specific guidance, including the term "percentage of completion," and replaces it with an overriding principle and five-step model:

1. Identify contracts with customers
2. Identify separate performance obligations in contracts
3. Determine transaction price
4. Allocate transaction price to performance obligations
5. Recognize revenue when (or as) performance obligations are satisfied

Following are a few key considerations for contractors preparing to implement the new standard.

Recognizing Revenue

Under current U.S. generally accepted accounting principles, the percentage-of-completion method is commonly used to recognize revenue based on costs incurred to date as a percentage of total estimated contract costs. Although the term "percentage of completion" is removed from the accounting guidance, the standard does provide for revenue to be recognized over time if at least one of these three criteria is met:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as it occurs.
2. The customer controls the asset as it's created or enhanced by the entity's performance.
3. The entity's performance doesn't create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

These criteria will generally be met with the performance of construction contracts, but if one of the criteria isn't met, the revenue will be recognized at the time the performance obligation is completed.

Identifying Performance Obligations

Under the new revenue recognition standard, revenue is to be recognized based on satisfaction of performance obligations on a contract-by-contract basis. Management will need to use judgment to determine if contracts include more than one distinct performance obligation. Promised goods or services are considered distinct when they are both:

1. Capable of being distinct because the customer can benefit from the good or service on its own or with other readily available resources, and
2. Distinct within the context of the contract—the good or service to the customer is separately identifiable from other promises in the contract.

Accounting for Change Orders

Change orders are common occurrences for many contractors, and the new guidance makes accounting for them more complex. Under the new variable consideration guidance, accounting for change orders will depend on the type of modification. A change order that adds distinct goods or services for additional consideration that reflects a standalone selling price would be recognized as a separate contract. If a change order doesn't add distinct goods or services, the contract modification would be accounted for on a combined basis, with the original contract using a cumulative catch-up approach. When change orders are unpriced, additional judgment will be required.

Changes in the Cost-to-Cost Method

For contractors that have historically used the percentage-of-completion recognition method based on cost-to-cost measures, the new guidance excludes certain costs from the calculation. Only the costs incurred that contribute to the progress of satisfying the contract will be included in the estimated and actual costs; the cost of defective material, inefficiencies due to errors, etc., would be excluded from the calculation of progress measurement and expensed as incurred. Management will need to be diligent when determining which costs or labor hours should be included in the measurement of progress.

Implementation Considerations

Finance executives in the construction industry should consider these steps when implementing these changes:

1. Evaluate the new standard's expected effect on the company's revenue recognition based on contract types.
2. Determine whether all information needed to implement the new standard is being captured by the company's finance and/or information technology systems.
3. Communicate to company stakeholders the new standard's potential effect.

Matthew D. Cash, CPA is a member of BKD National Construction & Real Estate Group and has more than 10 years of experience providing audit and review services to clients in the construction industry. He serves as the construction industry team leader for BKD's Southern Missouri practice unit. He can be reached at mcash@bkd.com or 417.865.8701.

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feature

The Intricacies of Underwriting Notary Bonds—

The Commercial Bonds Critical to Our Daily Business Transactions

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SURETIES OFTEN ISSUE NOTARY BONDS IN LARGE BATCHES. PREMIUMS CHARGED ARE RELATIVELY NOMINAL, AS THE VAST MAJORITY OF NOTARIES WILL COMPLETE THEIR COMMISSION WITHOUT EVER RECEIVING A BOND CLAIM.

BY JEFFREY M. FRANK AND OMAR J. HARB

ONE OF THE most common types of commercial bonds issued by sureties is the notary bond. However, given the relatively small penal sum (and premiums) for these bonds, they are often overlooked in the industry. However, they hold an important role in the daily transaction of business, especially real estate transfers. This article will provide a brief overview of notaries, notary bonds, and other issues relating to such bonds, including underwriting concerns.

I. Overview and Purpose of Notary Bonds

A. WHAT IS A NOTARY?

A notary public is commissioned by local governmental authorities (often, a state or county) and charged primarily with certifying the identity of a party who is signing (or has signed) a document. Any document can require notarization, but among the most frequent are real estate documents (deeds, mortgages, etc.) and legal documents (affidavits, agreements, releases, etc.).

No matter what the document, the primary purpose of the notary is to assure any party relying on a document's signature that the person signing is, in fact, the person who is supposed to be signing. In other words, the notary is involved to confirm the identity of the signing party.

Because the notary is appointed by a governmental unit, and given the requirement that a notary ensure the identity of a signing party, notaries are important in that they provide a level of comfort to parties engaged in a transaction.

B. PROCEDURE FOR BECOMING A NOTARY

While notaries are commissioned by a governmental unit, notaries are not generally governmental employees. Typically, the only requirement to become a notary is that an application be submitted and a bond be obtained. The governmental unit responsible for commissioning notaries may perform some minimal background check (for a criminal record, for example) before granting the notary commission.

In some instances, the notary is required to obtain a notary bond prior to submitting the application. In other states, the notary first applies to become a notary and, once accepted, obtains a bond. In either case, a notary must contact a local bond producer to obtain a notary bond. Those producers typically provide simple forms for the prospective notary to complete in order to obtain the bond, as well as any necessary supplies (such as stamps and seals, along with blank notary log books).

C. PURPOSE OF BONDS

As with other bonds, the purpose of a notary bond is to compensate persons or entities incurring a loss based on the misconduct of a notary. Without a bond, aggrieved parties would likely have a very difficult time collecting any damages against notaries who may not have the financial ability to pay a judgment, which could be many thousands of dollars. Bonds are statutorily required, and it is often the case that the specific language in the bonds are set forth by statute as well.

II. Underwriting Issues

A. PENAL AMOUNT OF BONDS

Some states do not require notary bonds at all, while other states require bonds in differing penal amounts. These generally range from $500 to $25,000.[1] The bond amount is generally set at the state level, but notary bond amounts in Kentucky vary by county.

A surety's liability is generally limited to the penal amount of the bond over the entire length of the notary's commission, which varies by state. Typically, a notary's commission lasts four to six years.

B. ISSUANCE OF NOTARY BONDS

As opposed to many bonds that are written individually, sureties often issue notary bonds in large batches. Premiums charged are relatively nominal, as the vast majority of notaries will complete their commission without ever receiving a bond claim.

C. NO INDIVIDUALIZED UNDERWRITING

While sureties will review financial backgrounds and work history of bond applicants with respect to various contract and commercial bonds, there is not the same level of scrutiny with respect to notary bonds. Generally, sureties ensure only that the bond applicant has been deemed a proper candidate for a notary commission by the governmental unit, and there is no further inquiry by the surety. In other words, there is no individualized underwriting that takes place prior to the issuance of a notary bond.

D. E&O COVERAGE

The business model for notary bond producers has trended toward offering the prospective notary a free errors and omission policy, which would cover the same length of time as the notary commission. The amount of coverage is typically $10,000, but additional coverage can be purchased by the notary for an additional premium.

These policies typically provide that the insurer will pay the notary's defense costs with respect to a claim made against the notary based on a notarization within the policy period. The policy would also cover liability found against the notary with respect to such notarization. However, many policies are "burning limits" policies, which provide for a combined policy amount covering both losses and costs/expenses. Accordingly, once the insurer has spent the policy limit in expenses related to the defense of the notary, no further amount will be available to pay a loss or judgment against the notary. Note also that these policies typically exclude intentional conduct by the notary, thereby precluding coverage to the extent the notary knowingly notarizes a document in contravention of his or her statutory duties.

III. The Duties of a Notary

A. WITNESSING A PERSON'S SIGNATURE

A notary's duties are generally governed by statute.[2] One of those duties is to be in the presence of the signing party at the time of the notarization. Note that the notary is not necessarily obligated to witness the person actually signing the document, as long as the person acknowledges the signature to the notary, in person.

B. CONFIRMING THE IDENTITY OF THE SIGNING PARTY

In addition to being in the presence of the witness at the time of notarization, the primary role of the notary is to confirm the signing party's identity. Many states' statutes enforce this obligation through a requirement that the notary obtain "satisfactory evidence" of the person's identity. Satisfactory evidence can be obtained in one of three ways, typically:

1. Personal knowledge by the notary of the person signing the document;
2. Verification of identity through a driver's license or a similar identification card; or
3. Obtaining the sworn word of a credible third party who knows both the notary and the signing party.[3]

C. KNOWLEDGE OF THE DOCUMENT CONTENTS

Notaries are generally not required to read and/or understand a document prior to notarization. However, a notary could be deemed to have breached his or her duties by notarizing a document that the notary knows to be false or contains blank spaces.[4]

D. MISCELLANEOUS REQUIREMENTS

State laws may require the notary to take other actions or precautions. For example, some states may require notaries to maintain a notary log, in which they keep specific records of each notarization. Other states might not require the log but mandate that a notary who maintains a log must not dispose of it for a certain number of years.

Additionally, some states may require that a notary maintain his or her seal/stamp or notary log in a secure location, such as a safe, locked drawer, or cabinet.

E. ETHICAL CONCERNS

While not legally binding on a notary, the National Notary Association has put together a Notary Public Code of Professional Responsibility.[5] Because statutes do not always cover every situation a notary might face, the Code of Professional Responsibility provides further guidance to notaries in performing their duties.

IV. Claims Issues

A. NOTIFICATION OF CLAIM

A surety might receive notice of a claim in one of two ways. First, it may receive notice from a claimant directly. For example, a person who has sustained damages by virtue of an improper notarization could make a claim directly against the notary bond surety. The claimant can generally obtain a copy of the notary bond from the state or county.

The other possibility is that a claim is made only against the notary, as persons often are not aware of the existence of a notary bond. The notary then might contact the surety, seeking a defense under an E&O policy. Note that this initial contact would often come directly to the bond producer, rather than the surety itself, as the producer is the one with whom the notary first dealt to obtain the bond. Accordingly, the producer would then be in a position to pass the claim along to the surety itself, which will make a determination with respect to defense of the claim.

Even in the absence of an E&O policy, the notary may notify the surety (or producer) of a claim. However, in that case, the surety has no obligation to pay for the notary's defense of a claim or lawsuit.

B. WHO IS A PROPER CLAIMANT?

A claimant is typically a person, entity, or governmental agency that has suffered monetary loss through the official misconduct of the notary. This could be the person whose signature was forged on a deed, causing that person to lose possession of the property. It could also be a mortgage holder that unknowingly provided a loan to (and accepted a mortgage from) a person who obtained real estate by way of forgery. In the latter case, the mortgage would likely be deemed null and void, given that the true title holder of the property (once the forged deed is set aside) did not authorize the mortgage or receive any of the funds from the loan.

A claimant could also be a surety that relied on a signature on an indemnity agreement, to the extent the signature later proved to be a forgery, despite the fact that it was notarized.

Note also that some state statutes may require the claimant to obtain a judgment against the notary prior to making a claim on the notary bond. To the extent both the notary and the surety are named initially as parties to a lawsuit, the surety could take the position that it should be dismissed from the suit until a judgment against the notary is obtained. A surety may sometimes opt to remain in the suit, to better control the matter and ensure that the proper defenses are raised.

C. DAMAGES RECOVERABLE

Damages are limited to the penal amount of the bond. As noted above, the statutes and/or bonds usually require proof of "monetary loss." Accordingly, there may be no damages from a technical violation by the notary, such as a failure to maintain a notary log.

In some situations, costs and attorneys' fees may be recoverable from a notary or the surety, depending on the wording of the bond and/or statute. While general litigation fees and expenses may not be recoverable, a court may find that the costs (including attorneys' fees) of quieting title constitute the damages suffered by a person whose signature was forged, causing him or her to lose title to the property.

Note that, while the surety's liability is limited to the penal amount, there is no similar limit to the amount of liability faced by the individual notary.

D. DECISION TO DEFEND

Because penal limits of notary bonds are often very small compared to the surety's exposure with respect to other bonds, a surety must decide whether and to what extent it defends a claim on a notary bond. For example, in those states that require a $5,000 (or less) notary bond, the surety may determine that the cost of litigation will exceed that amount. Even to the extent a surety decides to defend a claim on the bond, the litigation may necessarily involve less discovery than other matters, in order to keep expenses to a minimum. A surety should be aware, though, that a decision to pay a claim over the notary's objection could result in a later assertion by the principal that the surety wrongfully paid the claim. In that case, the notary may defend a subsequent indemnity lawsuit by arguing that the surety knowingly paid an invalid claim as a "volunteer."

V. Defenses of Notary and/or Surety

A. COMPLIANCE WITH STATUTORY DUTIES

First and foremost, a notary or surety can defend on the basis that the notary's conduct conformed with statutory obligations. To the extent the notary can prove (by way of the maintenance of a notary log, or the testimony of other witnesses who were present) that the notary obtained "satisfactory evidence" of the person's identity, the notary may have no civil liability. This may be true even if it is shown that the signature was a forgery. For example, to the extent the notary was shown false identification, the notary may be able to show that he or she nevertheless performed his or her duties in reliance on that identification.

In some cases, it may be necessary to obtain an expert handwriting analysis in order to prove that the signature is genuine despite claims to the contrary by the signing party. In any event, the best defense to a notary claim is that the notary did nothing wrong.

B. LACK OF PROXIMATE CAUSATION

Another potential defense is that, despite there being an admitted breach of duty by the notary, such breach did not "proximately cause" the injury to the claimant. For example, if a notary did not actually meet with the signing party at any time, the notary would have breached his or her duties by notarizing the document nevertheless. However, to the extent the signing party actually *did* sign the document in question, the notary's breach would not have been a "proximate cause" of any damages. In other words, the notary's job was to ensure the identity of the person signing. If the identity of the person signing is not in question, then there were no damages flowing from the breach by the notary. This provides another potential defense to a notary and his or her surety.

C. MISCELLANEOUS DEFENSES

There may be other defenses of which a notary or the surety may avail themselves. For example, to the extent the notarized document contains inaccuracies, the notary should not be responsible for the contents of the document. However, as noted above, a notary should ensure that there are no blanks in the document.

Additionally, the notary may have a statute of limitations defense, depending on when the notarization took place and when the aggrieved party knew or should have known about the issue. Because a surety is typically entitled to assert the defenses of the principal, the surety may also have the same statute of limitations defense.

Note that the notary statutes might not contain a separate statute of limitations, in which case the general tort statute of limitations is likely the one to which a court would look with respect to claims against the notary. However, this could provide a problem because the statute of limitations relating to the surety might be the potentially longer *contractual* statute of limitations, as the claim against the bond is based on a contract. In that case, the surety should still seek to apply the shorter tort limitations period for the claim against it, given that a surety should not be liable to the extent the principal is not liable.

VI. Indemnity Issues

As noted above, there is typically no individual underwriting with respect to notary bonds. Accordingly, sureties and/or bond producers typically do not obtain written indemnity agreements from the notaries. In that case, sureties would be left to argue an entitlement to indemnification based on that state's common law of indemnification, which provides that a surety is entitled to reimbursement from its principal for any losses related to the issuance of a bond for that principal.

Note, however, that, depending on the state, common law rights may not include a right to reimbursement for costs and attorneys' fees. Accordingly, without an indemnity agreement, a surety may only be entitled to recover its actual losses, and not its expenses incurred with respect to defending a claim or a lawsuit.

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End Notes

1 For information on bond requirements in each state, see The American Society of Notaries' website at *https://www.asnnotary.org/?form=stateinfo*.
2 Various states have adopted the Model Notary Act, a copy of which can be found at the National Notary Association's website. See *https://www.nationalnotary.org/file%20library/nna/reference-library/2010_model_notary_act.pdf*.
3 See Model Notary Act §2-20 (2010).
4 See Model Notary Act §5-8 (2010).
5 The Notary Public Code of Professional Responsibility can be viewed or downloaded at The National Notary Association's website, at *https://www.nationalnotary.org/knowledge-center/reference-library/notary-public.code-of-professional-responsibility*

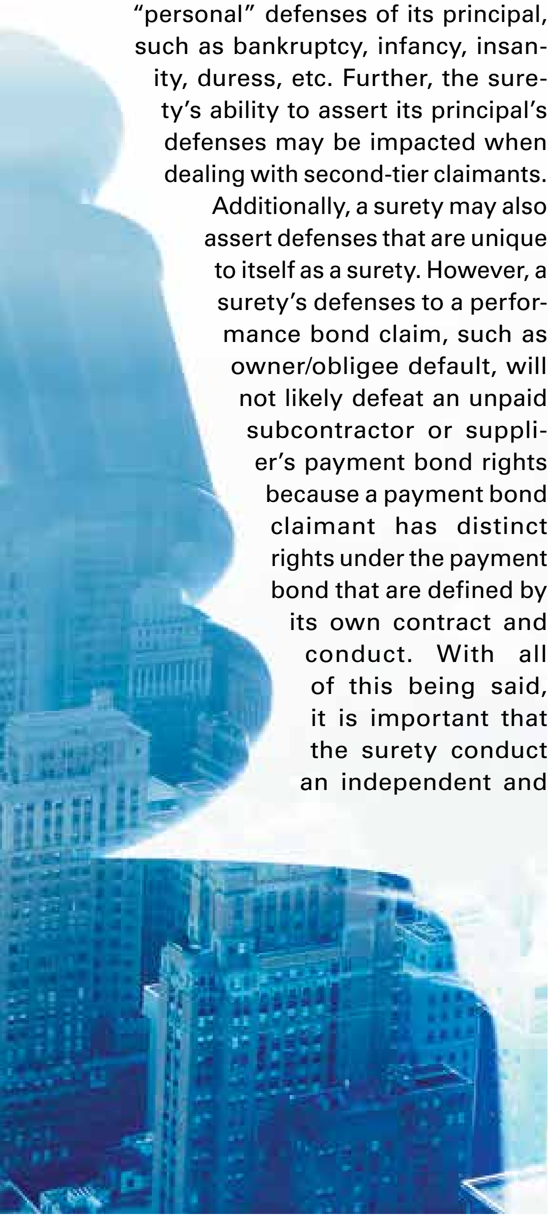
Payment Bond Defenses
To Pay, or Not to Pay: That is the Question

BY LAUREN E. RANKINS, ERICA DEL AGUILA, AND ANIUSKA ROVAINA

Introduction

The starting point of this article is a maxim that is the very essence of suretyship: the surety is not liable unless its principal is liable on the underlying obligation. As such, a surety is entitled it assert its principal's defenses against a claim for labor or material furnished to the bonded project. This general rule is true even if the principal does not assert the defenses itself or is barred from doing so by an unrelated legal disability. The surety may not, however, maintain a defense that has already been waived by the principal nor may the surety assert the "personal" defenses of its principal, such as bankruptcy, infancy, insanity, duress, etc. Further, the surety's ability to assert its principal's defenses may be impacted when dealing with second-tier claimants.

Additionally, a surety may also assert defenses that are unique to itself as a surety. However, a surety's defenses to a performance bond claim, such as owner/obligee default, will not likely defeat an unpaid subcontractor or supplier's payment bond rights because a payment bond claimant has distinct rights under the payment bond that are defined by its own contract and conduct. With all of this being said, it is important that the surety conduct an independent and objective investigation to determine whether it has the factual, contractual, and legal authority to assert such defenses. Below is a general overview of only some of the defenses that may be available to a payment bond surety.



Material Breach

A claimant's material breach of its contract may serve as a complete defense to a payment bond claim. A material breach may occur if the claimant unjustifiably abandons the project, fails to reach substantial completion, or fails to perform its work in accordance with the contract documents. However, this defense may fail if the claimant's performance under its contract is preceded by the principal's own prior material breach, such as nonpayment or wrongful termination.

Recoupment or Setoff

Generally speaking, against a first-tier claimant a surety may setoff any costs incurred by its principal to complete or remediate claimant's work and any costs incurred as a result of the claimant's delay. But authorities differ on a surety's setoff rights against a second-tier claimant. Some courts have found that the principal is not barred by the lack of privity from recouping its corrective expenses because the second-tier claimant may only recover for "sums justly due." *See United Structures of America v. G.R.G. Engineering*, 9 F.3d 996 (1st Cir. 1993). However, other courts have found that a surety may not charge correction and delay damages against a second-tier claimant because of the lack of privity between the principal and the second-tier claimant. *Compare United States* ex rel. *Martin Steel Constructors v. Avanti Constructors*, 750 F.2d 759 (9th Cir. 1984).

Payment

Payment may also serve as a defense to a payment bond claim. However, this defense will only hold up if actual payment is made and received. This means that a promissory note or bounced check will not discharge the surety of its bonded obligations.

Contingent Payment Clauses

Contingent payment clauses may also be asserted by sureties as a defense of their principals in order to shift the risk of non-payment by project owners to subcontractors. Contingent payment clauses generally fall into two categories: pay-when-paid clauses and pay-if-paid clauses.

Pay-when-paid clauses provide that a contractor will pay its subcontractor within a certain amount of time after receiving payment from the owner. Pay-when-paid clauses serve as a timing mechanism that postpone a contractor's payment obligations to its subcontractors, but do not shift the entire risk of owner non-payment to subcontractors.

On the other hand, pay-if-paid clauses make payment by an owner to a contractor a condition precedent to a contractor's payment to its subcontractor, thereby shifting the risk of non-payment entirely to a subcontractor. Pay-if-paid clauses will generally be enforced only if the language in the contract makes it expressly and unequivocally clear that the parties intended the contract to include the pay-if-paid condition precedent. However, some states have enacted statutes that prohibit the enforcement of pay-if-paid clauses as void against public policy.

Contingent payment clauses will not be enforced or considered as a valid defense where a principal is the cause for the non-payment or delay in payment from the owner. Notably, some jurisdictions have also found that sureties may not raise contingent payment clauses as a defense unless they expressly incorporate the terms of their principal's subcontract into the terms of the bond.

No-Damages-for-Delay Clauses

No-damages-for-delay clauses prevent a subcontractor from recovering delay damages against a contractor.

Delays in construction are not uncommon; therefore, these provisions serve as a tool for allocating the costs for delays between the parties. However, courts across the majority of jurisdictions have recognized the following exceptions to the enforceability of no-damages-for-delay clauses: (i) bad faith or other misconduct by the contractor; (ii) active interference (an affirmative or willful act) interfering with a subcontractor's work; (iii) a delay that is so unreasonable that the delayed party could have abandoned the project; (iv) a delay not contemplated by the parties at the time of their agreement and that lies beyond the contractor's intended scope; and (v) a delay caused by the contractor's gross negligence. This is a non-exhaustive list of exceptions, as they are highly fact specific and vary on a case-by-case basis and by jurisdiction.

WHEN A PAYMENT BOND CLAIMANT MAKES A TIMELY AND PROPER PAYMENT BOND CLAIM, THE SURETY MUST CONDUCT AN INDEPENDENT AND OBJECTIVE INVESTIGATION TO DETERMINE WHETHER SUCH DEMANDED MONIES ARE TRULY OWED TO THE CLAIMANT.

Waiver, Estoppel, and Related Defenses

Another set of defenses available to sureties are those in which the claimant surrenders its rights that were previously available to the claimant either through novation, a waiver, or equitable estoppel.

For the defense of novation, the parties agree to replace the terms of the original agreement with a second agreement that ultimately extinguishes the obligations under the original agreement. Typically, to effectuate novation of a binding agreement, there must be (i) a previously valid contract; (ii) an agreement between the parties to cancel the previous contract; (iii) a new valid and binding contract; and (iv) an agreement between the parties that the new agreement will replace and extinguish the old agreement. The assent to the second agreement would then release the parties from any liability under the previous agreement. Consequently, a new agreement between a contractor and a subcontractor will also release the surety from its obligations or liabilities under the former agreement.

A second method in which a claimant may forgo previously held rights is through the execution of a waiver. A claimant can waive its payment bond rights by entering into a written agreement with the parties to the payment bond. The Miller Act considers a waiver of a civil action on payment bond to be valid so long as the waiver is (i) in writing; (ii) signed by the person whose rights are waived; and (iii) executed after the person whose rights are waived has furnished labor or material outlined in the construction contract. Thus, a claimant cannot waive its payment bond rights prior to supplying labor or materials. For this reason, some jurisdictions find that waiver provisions contained in construction contracts are unenforceable.

Finally, a claimant may lose its payment bond rights due to its own actions. Under the doctrine of equitable estoppel, if a claimant conceals facts or makes false misrepresentations to the principal or its surety, and knows the other party will rely on such statements, then the claimant's assertion for damages against the principal and its surety may be barred. In order for a surety to assert estoppel, the following elements must be met: (i) the claimant actually or constructively knew the material facts the other party relied upon; (ii) the claimant intended for the other party to rely on the concealed facts or misrepresentation; (iii) the contractor or surety did not know or have means to know the material facts; and (iv) the contractor or surety acted to its detriment on the claimant's misrepresentation.

Conclusion

When a payment bond claimant makes a timely and proper payment bond claim, the surety must conduct an independent and objective investigation to determine whether such demanded monies are truly owed to the claimant. The surety's investigation should include a thorough review of the underlying contract, the payment applications, invoices, schedules, project correspondence, meeting minutes, etc. The surety should also seek an understanding of the nature of the project and the claimant's work on the project, because, if the claimant caused delays or if its work is defective, that may be a partial or total defense to the bond claim. The surety's investigation must not be hasty and may require the assistance and advice of counsel or a consultant to ensure that its analysis of the claimant's payment bond claim is comprehensive. So, to pay, or not to pay; the results of the surety's investigation should answer that question.

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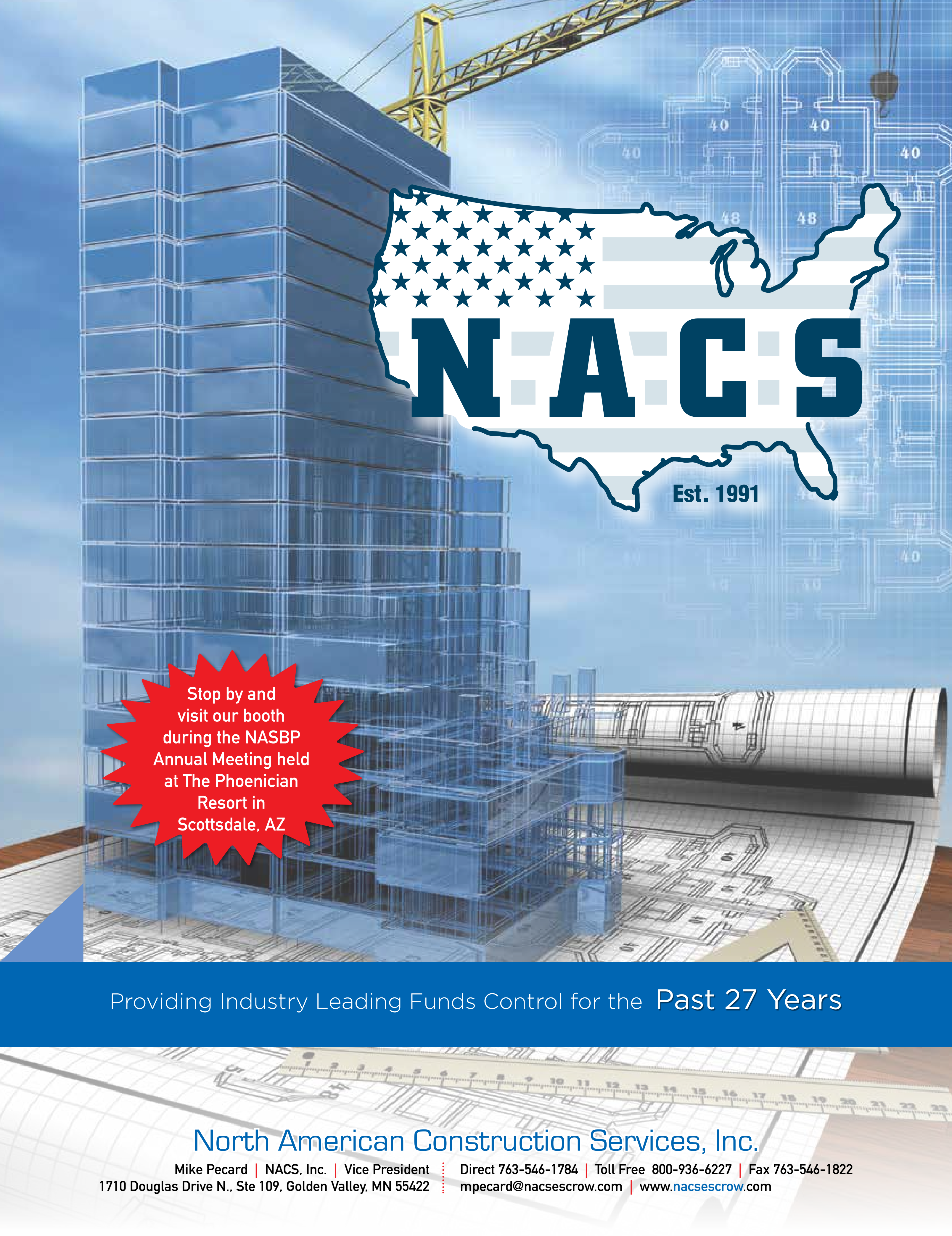
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feature

PTS Treatment Breakthrough Gains Momentum

A NASBP-Supported Charity Research Initiative

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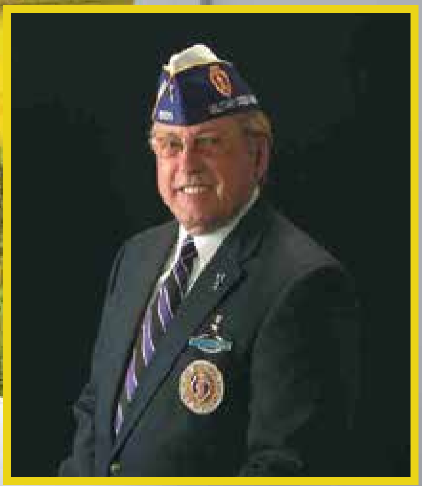
Christopher Kato



Peter Comstock

(R&R Project)

EXISTING THERAPY PROGRAMS have provided only limited relief for military veterans with Post Traumatic Stress Disorder (PTS). The Research and Recognition Project (R&R Project) has developed a new treatment, Reconsolidation of Traumatic Memories (RTM), that eliminates the clinical indicators of PTS in 90 percent of those receiving treatment.

NASBP members have raised more than $340,000 since 2015 for research studies to prove the effectiveness of RMT. Now the project team needs assistance in raising funds to train more counselors and reach a much larger population across the country.

Two veterans who have gone through the program are sharing their stories as a way to illustrate just how powerful—and how important—this breakthrough treatment is.

Understanding the Why of Things

Peter Comstock served in the Army for four years and was wounded twice. But the Vietnam veteran has spent more than 40 years struggling with the devastating effects of PTS—nightmares, night sweats, flashbacks, anger and other emotional problems.

"When I first got back, the way I handled it was drinking. I'd drink myself to sleep every night, hoping I didn't have the nightmares. I would wake up three or four times a week, thinking I was being shot in the chest and looking for blood," he said.

But the problems continued after he stopped drinking. "I couldn't figure out why I was doing what I was doing, why I was treating my family the way I did, why I had the anger I did," he said. Counseling through the Veterans Administration and private therapists brought a little relief, and so did some books on PTS written by an ex-Marine. "The thing I got out of that was that nobody was going to fix me; I was going to have to do this myself," he said.

Comstock learned about Dr. Frank Bourke's RTM therapy through another therapist who had developed a similar program. He became involved in Bourke's efforts to scientifically prove that the therapy worked through a neurological study using EEGs to measure the effects of RTM on the brain. In the pilot studies, the pre-treatment scans showed clear indicators of PTS; post-treatment, those areas disappeared.

During his own treatment, Comstock recalled details of a firefight in which he had been wounded; he hadn't previously remembered letting lose the handle of a grenade before he charged a bunker and threw it in. Another trauma was his witnessing—on Christmas Day—the murder of a village chief by a Vietnamese army officer. Although he had blacked out the memory, the event ruined Christmas for him for many years.

The RTM experience gave Comstock some of the answers he sought. "To know the why of things was really important to me," he said.

The RTM process, which usually takes two or three sessions, allows veterans to remember traumatic events but disassociate themselves from those events so it no longer affects them emotionally. "Frank is not fixing anybody; we are actually fixing ourselves, because we find out why we did what we did, why what's going on is going on. It allows us to get through this thing and come out on the other side," said Comstock. He hasn't had nightmares, night sweats, or flashbacks since his treatment.

He cautions that the therapy won't solve everything. "It's not like you go through this and you never have a PTS problem for the rest of your life; there are other issues that you're going to need to work on with somebody," he says. But RTM helps people uncover the roots of the trauma so they can benefit from other help.

Changing the Perspective

Christopher Kato was just 17 when he signed up to serve as an Army medic. He spent eight and a half years in the service, much of that time in Iraq. Within his first month, the other medic in his platoon died in his arms. Those memories haunted Kato when he tried to sleep; if he finally dozed off, he would wake up several times a night soaking wet from night sweats.

During his time in Iraq, Kato became close friends with another serviceman, Doug Bauldwin; and they remained friends after their discharges. At that time, the only emotions Kato felt were anger and frustration; Bauldwin was not faring any better.

Attending the 2017 NASBP Annual Meeting are, pictured from left, Brian Ayres, then NASBP First Vice President Howard Cowan, Tom Padilla, Doug Bauldwin, and Christopher Kato

EXPRESS YOUR APPRECIATION WITH A DONATION

The R&R Project has proved that it can be a life-altering therapy for veterans with PTS. But the program needs funding now to assist the 700,000 others who are still suffering from its effects.

Please honor all our veterans by making a donation today to provide funding for additional trained counselors.

Donate by going to the NASBP/R&R Project Go Fund Me page at https://www.gofundme.com/randrNASBP.

"Doug was on a downward spiral. But I watched him change dramatically over about a month," Kato recalled. That was the month of Bauldwin's treatment.

Despite Bauldwin's obvious improvement, Kato says he was hesitant to participate because he feared he would lose the memory of the people who were part of the traumatic event. Although he was skeptical, he eventually agreed to do it.

By the second session, the program started to work. "I noticed that I had to change my shirt only once or twice in a nighttime," he recalled. After the third session, he no longer had the night sweats at all.

One of Kato's most traumatic experiences was treating a young girl for the third degree burns she had received when terrorists dumped boiling water on her. Each day he had to apply the antibiotic ointment that kept her from dying from infection. "Her screams haunted me," Kato said.

Through the RTM, he was able to take a broader perspective and reshape his memories. "One thing I never saw before was how tough that little girl was. And I had never seen the strength of her sisters, who were watching her get treated and were really supportive."

"Perspective is everything, and this changes your perspective. Change your perspective and you change your reality," he said.

Since the treatment, Kato's life has changed dramatically. Previously he was not able to concentrate on anything; today he has enough focus to run six businesses. He is also hoping to make a substantial contribution to the R&R Project. "I went through it, and I'm willing to take $50,000 out of my own pocket to help," Kato said. "That's how much I believe in this."

Getting Help to Those in Need

In four pilot studies, the RTM treatment has eliminated the PTS diagnosis more than 90 percent of the time. A pilot study at the Mind Research Network in New Mexico, which is using EEGs to measure brain activity, has shown similar results.

"This doesn't mean that their scores [measuring PTS] got better, which is called success in all of the other studies of different treatments. This is actual elimination of the diagnosis," said Dr. Frank Bourke, who developed the treatment. Unlike other months-long or years-long therapies, the RTM treatment takes less than five hours over a period of 5-7 days.

Since the publication of the research studies, many different groups have expressed interest in using RTM. Twenty-five counselors from the Veterans Administration received training in November 2017 and will provide the therapy to veterans along the East Coast. In addition, the R&R Project has an ongoing relationship with Walter Reed Army Medical Center and has done trainings for 50 of their clinical and research staff.

The RTM protocol can assist other people suffering from traumatic experiences. In New York State, where 24 percent of the 30,000 corrections officers have PTS, the Corrections Department has asked the R&R Project to train 300 counselors to help treat them. RTM could also help emergency medical technicians, rape victims, sexual abuse victims, and many more.

While these developments are promising, the R&R Project needs more funds now to carry on its work easing the emotional pain of veterans and others with PTS. "We have to start training counselors to get RTM out to the 700,000 or so vets who need it," said Bourke.

Building on its previous efforts, NASBP is asking its members, affiliates, and associates to help make this life-changing therapy available to many more veterans. Please help us in helping those who served our country resume the lives of peace and dignity they deserve.

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