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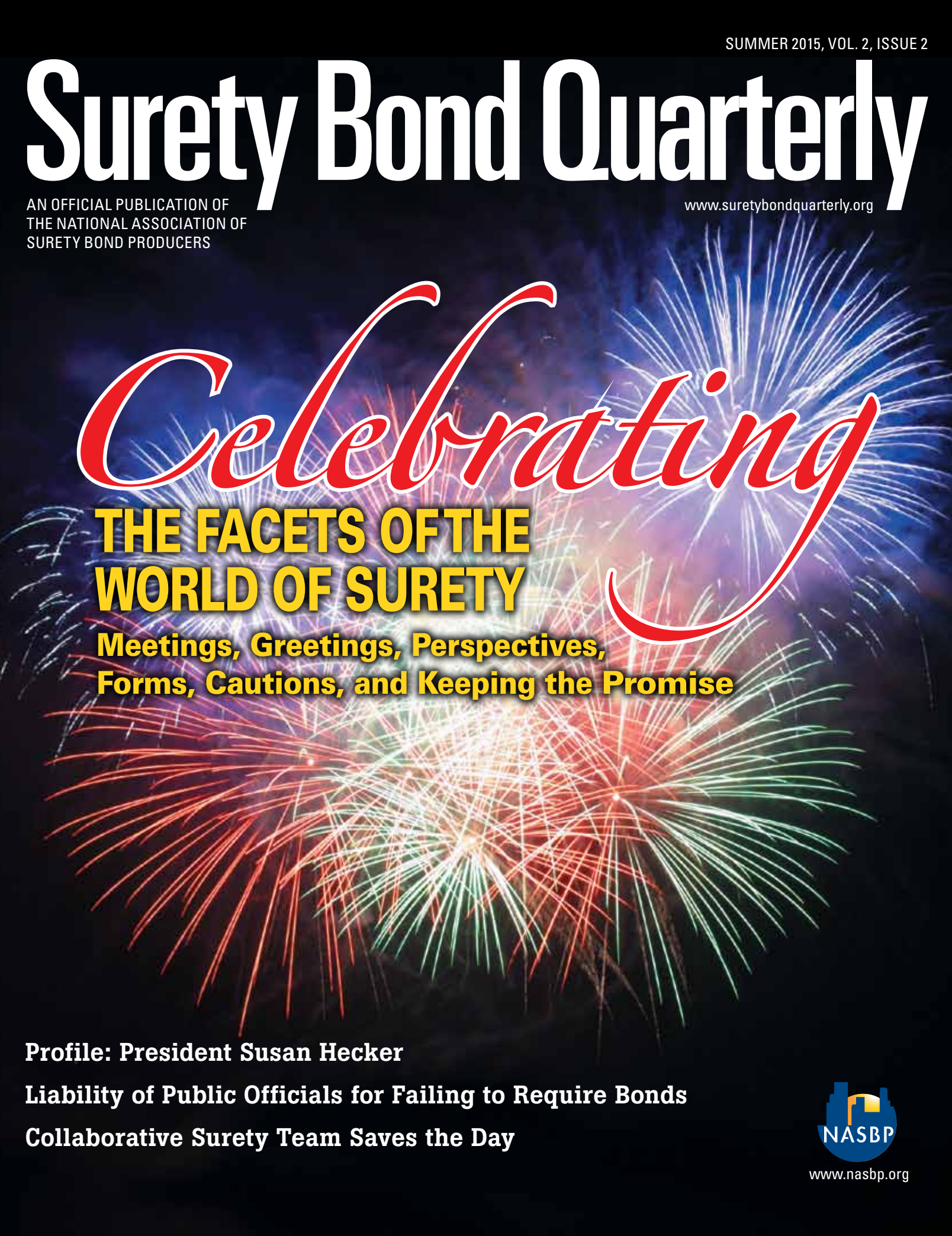

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Profile: President Susan Hecker

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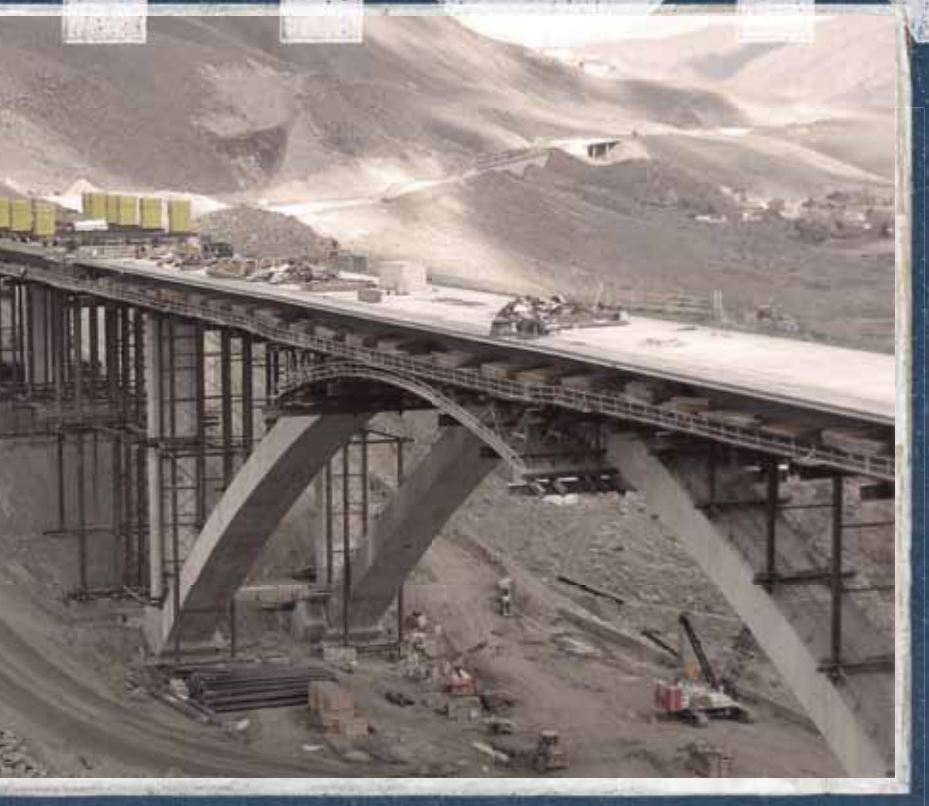

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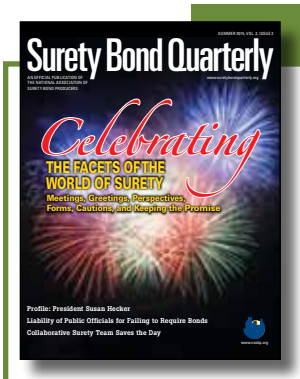

ON THE COVER

Summer 2015

Many facets make up the world of suretyship. Some of these facets are deliberated in this issue of *Surety Bond Quarterly*. Read about 2015-2016 NASBP President Susan Hecker of Arthur J. Gallagher & Co., the red flags all contractors should know to avoid claims, the importance of developing your leadership signature, the latest editions of the American Institute of Architects' design-build set of standard form documents, when public owners may face liability for failing to require payment bonds, and underwriting nuances of probate bonds.

View this and past issues online anytime at www.suretybondquarterly.org.

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There is Poetry in Surety Claims, Surely

If you think that poetry and surety are cut from different cloth, you may be surprised to learn that among the most accomplished and complex American poets of the twentieth century was a surety company executive, Wallace Stevens. Stevens attended Harvard, showing interest in writing and poetry, graduated from New York Law School in 1903 and embarked on a career first as a surety attorney, then as a surety company executive for the Equitable Surety Company of St. Louis and later, the Hartford Accident and Indemnity Company. He remained a surety man for the remainder of his career, never forsaking his surety executive position for academia, even though Harvard offered him a professorship in poetry later in life. Critics view his poetry as chiefly concerned with the transformative nature of the imagination, and he frequently was lost in his imagination rambling to and from his office in Hartford, Connecticut, as that was a favorite time to compose poetry.

As a surety executive and as a poet, Stevens was familiar with the concept of risk and of risk mitigation. He believed that a better world resulted from the elevation of imagination, but that such imaginative wanderings still needed grounding in the pragmatism of reality. Perhaps that sentiment held Stevens' feet steadfastly to his career as a noted surety claims expert, as such work requires careful, sometimes precarious, balance between imagination and pragmatism. Stevens, in fact, saw poetry and surety claims as stuff not too dissimilar. In a 1954 interview with *The New York Times*, Stevens related that he did not live a Jekyll-Hyde existence between his worlds of poetry and of surety claims:

> Anyway, here I deal with surety claims — claims on surety bonds. Poetry and surety claims aren't as unlikely a combination as they may seem. There's nothing perfunctory about them for each case is different.

Could truer words be spoken about the unique natures of poems and of surety claims, each being borne in original form? I believe the answer is self-evident in this issue of the *Surety Bond Quarterly*. A feature story, "Class Act: Surety Team's Cooperative Efforts Enable School To Open On Time," gives proof to the notion that, when imagination balanced with pragmatism is applied, a collaborative, satisfying solution to a difficult surety claim can be artfully scripted for the obligee.

Successful poems evoke the expression of ideas, feelings, and actions through the conduit of carefully selected words and phrases. The same can be said of successful contracts, which provide written expression of the parties' intentions and mutual obligations. Those that do not permit a clear picture of rights and responsibilities and that promote imagination unchecked by pragmatism serve only to undermine successful outcomes and business relationships. Such is the danger told in the article "Hiding in Plain Sight: Specifications as a Source of Risk," which illuminates the critical but little known role of the specifier in shaping the construction risk environment.

There is so much more in this issue that evokes ideas, feelings, and actions. Read about our 2015-2016 NASBP President Susan Hecker of Arthur J. Gallagher & Co., the red flags all contractors should know to avoid claims, the importance of developing your leadership signature, the latest editions of the American Institute of Architects' design-build set of standard form documents, when public owners may face liability for failing to require payment bonds, and underwriting nuances of probate bonds, all of which convey the kind of meter and rhyme that comprises the poetry of our industry.

I hope you will be able to find a quiet space and a few minutes to read this issue from cover-to-cover. Such imaginative wanderings may launch you on your own path to being a surety poet!

Warm regards,
Mark H. McCallum
NASBP CEO

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Practical Insights: What You Need to Know

Hiding in Plain Sight:
Specifications as a Source of Risk

BY UJJVAL VYAS

IN 2013, THE Construction Specifications Institute (CSI) engaged a company to undertake a study of the current and future state of specifications and that distinct sub-category of the design profession, specifiers. If the term "specifier" denotes a breed unknown to most in the surety industry, this is understandable. Contractors, subcontractors, owners, insurers, and others in the construction industry are largely unaware of the role that specifiers play in the production of the key information that rules the construction project. Most are also unaware that poorly prepared or incomplete specifications are a source of risk that's hiding in plain sight.

The instruments of service are the "drawings and specs" produced by the licensed design professional or firm during the construction documents phase of the underlying contract between the owner and the architect (generally speaking). The drawings and specs provide the visual and non-visual information the constructor needs to estimate, bid, schedule, and deliver the project. In the event of a default, the surety is responsible for assuring fulfillment of the performance of the contract through the information provided in these instruments of service and is held to a certain standard for completing what is in these documents.

It is commonly known that drawings are used primarily for parametrics, space planning, and aesthetic composition and are not warranted to provide exact dimensions or full descriptions of the products, assemblies, systems, and other requirements for compliance by the contractor. In fact, no significant estimation (either for general conditions or for construction services), bid packages, or scheduling can be done with the drawings alone. Contractual performance for contractors and subcontractors is determined by adherence to the non-visual information in the project manual.

Poor instruments of service produced by the design professional will negatively impact the whole process. Two CFMA/FMI studies show this to be the case, and there is no sign that the trend will reverse any time soon.[1] The result of improper, ambiguous, contradictory, or unclear specifications can be felt throughout the process, causing major problems for the constructor and eventually costing the owner substantial sums. Constructors have known this for a long time, but the magnitude of the impact on owners has come to light as a result of CSI's study.

The common problem of poor specifications raises several issues for constructors. Estimating, which is often done in the context of severe time constraints, becomes an exercise in guesswork. This increases the likelihood of contractor non-performance and can also put pressure on the contractor's performance for other projects in progress, which raises the specter of default.

Poor specifications also create circumstances that encourage opportunistic behavior by constructors during bidding, which ends up being detrimental to the owner. A contractor may understand that the specification is improper or ambiguous and will submit a bid knowing that change orders will ensue. This creates an apparent lower bid masking the true higher cost. Another reaction to poor specifications, especially in those areas that can have large disparities in pricing, is for the contractor to add some increased percentage of contingency in a bid. This makes it impossible for the owner to acquire robustly comparable bids for selection. Unfortunately, this type of gamesmanship has become all too common.

Unbeknown to most owners, insurers, and bond providers, specifiers are directly involved in the Division 01 portions of the specifications, which determine contractual compliance with the General Conditions of the contract. What, when, and how submittals are to be prepared, submitted, and approved is just one area that is outlined in the specifications; and insurance provisions also can be altered and amended by specifications. However, specifiers rarely have access to the underlying contracts between the owner and the design professional or the owner and the general contractor.

Furthermore, specifiers are not versed in the legal or risk issues associated with contract or insurance provisions and even less so with surety issues. The fact that the specifier — not legal, insurance, or risk management personnel — creates the requirements for fulfillment of the underlying contracts makes for a dangerous situation.

Even more troublesome for the surety industry, it is common, under the well-intentioned theory of protecting

THE INSTRUMENTS OF SERVICE ARE THE "DRAWINGS AND SPECS" PRODUCED BY THE LICENSED DESIGN PROFESSIONAL OR FIRM DURING THE CONSTRUCTION DOCUMENTS PHASE OF THE UNDERLYING CONTRACT BETWEEN THE OWNER AND THE ARCHITECT.

the owner's interests, for the specifier to make changes to the warranty time periods or other attributes that can significantly change the underlying risks of the bond. For example, the specifier might change the general conditions so that the contractor is made a co-guarantor of equipment and materials for the full term of the warranties offered by the supplier and/or manufacturer. In a more common scenario, a specifier will simply fill in the blank for warranty requirements with what he or she believes is a suitably high number to protect the owner. In other circumstances, the specifier might alter liquidated damages or consequential damages provisions as well.

Research shows that many of these risk issues are exacerbated by the low prestige in which specifiers are held by the architectural profession. This low prestige, combined with the predilection of designers to use a disproportionate amount of the design fee for visual work alone, leaves specifiers with unreasonably short time frames to do their work. This increases the likelihood of errors that can create heightened risk for the project.

The fact that an unrecognized core node of risk is now in the open means that it can be productively addressed to benefit all parties on the project. Given the rapid expansion of new mechanisms for information acquisition in the construction industry, it is crucial that sureties pay attention to the quality of specifications to help ensure project success. ●

Ujjval K. Vyas, PhD, JD, is a construction attorney and principal of Alberti Group, a Chicago-based interdisciplinary consultancy specializing in risk management, performance, and policy related to the built environment. The Alberti Group conducted the CSI research report discussed in this article. Vyas can be reached at uvyas@albertigroup.net or 312.810.1008.

Reference

[1] *See* "Seventy-four percent of the owners polled ..." and following paragraph in 2004 FMI/CMMA Owners' Survey, p. 7, available at http://www.cmaafoundation.org/files/surveys/2004-survey.pdf. These surveys indicate that there has been a concern with design document quality for quite some time. Anecdotally, there has been an even longer period of decline. *See also* "The 2010 FMI/CMAA Owners' Survey indicated ..." in 2010 FMI/CMAA Owners' Survey, p. 5, found at http://www.cmaafoundation.org/files/surveys/2010-survey.pdf.

2015-2016 NASBP President Susan Hecker

2015-2016 NASBP Leadership, from left, Third Vice President Robert Shaw, First Vice President Lynne Cook, President Susan Hecker, Immediate Past President Tom Padilla, and Second Vice President Howard Cowan

HECKER SEES THE SURETY INDUSTRY AS OFFERING MANY OPPORTUNITIES FOR SUCCESS FOR PEOPLE WHO ARE WILLING TO WORK HARD AT ACHIEVING THEIR OWN OBJECTIVES.

President Susan Hecker

Get to know NASBP's 2015-2016 President

WHEN NASBP'S 2015-2016 President Susan Hecker considers everything she's gained from her association membership, one benefit tops all the others: "It's all the friendships I've made," she said. "There's not a place in the country where I can't pick up the phone and find someone to help me if one of our customers has an issue."

Hecker, Executive Vice President and National Director of Contract Surety for Arthur J. Gallagher & Co. in San Francisco, has been developing those friendships for 38 years. She got involved in the surety industry by accident—literally.

"I was in nursing school, studying for an exam, cooking and watching TV at the same time. A pot of grease caught on fire, and I was badly injured, spending a month in the hospital," she said.

The hospital stay delayed her nursing classes, so Hecker accepted a job in the bond department with Fireman's Fund in 1977. "I really loved it, and after a couple of years I wanted to become an underwriter," Hecker recalled. "Back in those days, there were female underwriters, but they were either on the fidelity side of the business or in commercial surety, but I knew my passion was working with contractors."

With the support of management, Hecker entered Fireman Fund's training program in 1980. She remained with the company for 20 years, eventually transferring for a management position. When she left the company, she was running the flagship surety operation in San Francisco.

"I had a number of opportunities to go over to the broker's side, but never the right opportunity at the right time. Then along came one that was," Hecker said. She joined Lamberson Koster & Company, which had just been acquired by Arthur J. Gallagher, which needed surety continuity and creation of a construction practice.

Hecker has never regretted her move from nursing to surety. "I like there are tangible things you can see," she said. "I'm making a contribution and making a difference. Whether our customers are building roads, buildings or something else, I'm adding value to their businesses. Many families get fed and housed as a result of the projects I've helped those businesses acquire and manage over the years."

"I'm incredibly fortunate to represent a wonderful group of companies, where I'm a trusted partner helping people make good business decisions. It gives me an enormous sense of accomplishment. What we do is important," Hecker added.

Showcasing new leaders

During her decades of involvement with NASBP, Hecker has served on the Membership Committee and chaired the Government Relations Committee. She served two terms on the NASBP board as a Director-at-Large before entering the chairs.

As a long-time, active member, she understands how important it is for those with years of experience in the industry to share the knowledge they've gained with younger generations.

"From a talent perspective, our industry didn't do a good job of training people for a long time, so we have a big gap," she said. She credits Stephen Cory, NASBP's 2006-2007 President, for seeing that need during his tenure and setting up the 5-15 Leadership Circle Committee in response.

"The 5-15 Committee includes people who've been in the business for at least five years, but fewer than 15," Hecker explained. Agencies nominate people they believe have the potential to be industry leaders. NASBP leadership gives special attention to those members as they attend its meetings and schools, provides a mentor, and creates opportunities for access to the executives of many surety companies. "We're developing a whole group of young all-stars. They're ready for the national stage, and I can't wait for everyone to see what we can see," Hecker said.

Two of the emerging leaders, Bryan Ayres with LA Surety Solutions in Louisville and Chad Martin of TIS Insurance Services in Knoxville, will serve as her annual program co-chairs. "Part of the 2016 program at The Broadmoor will be devoted to these young people," she said. "We want to show their employers how their investment in NASBP is benefitting their companies, and how the 5-15 is helping their employees grow, which hopefully will result in a thriving business."

Hecker is planning a Leadership Conference on October 22, the day before NASBP's Mid-Year Board Meeting at the Omni Hotel in Nashville. Rick Ciullo, Chief Operations Officer at Chubb Surety, has agreed to sponsor facilitators for the event. "We're using a consulting firm, which is working with several of our Past Presidents to get feedback, so the program will be tailored towards surety professionals. I'm really excited about it," Hecker said.

She emphasizes this conference is not geared just to emerging leaders but is open to everyone. "I'm trying to create ways people can further develop so they can build their own thriving businesses—a component necessary to have fully engaged people working on behalf of industry issues."

Members' success is essential to the association's success, she added. "You have to be working for a thriving business or you have no time to be out there doing the activities that move the industry forward. I want to get the message out that we're providing tools to better our companies."

In the closing paragraphs of her acceptance speech at the San Diego Annual Meeting, Hecker made a special request of the NASBP's affiliates to help create their own 5-15 Committee for emerging surety underwriters: "In closing, I have a request for our affiliates here in the room. Your young leaders want to engage with ours. We hear it on a regular basis not only from our side, but also from yours. I really do understand your reluctance to form your own Affiliate Committee to mirror our 5-15 out of fear that, when you identify your up-and-coming all stars, it may make it easier for people to poach them. But I'm going to challenge your thinking."

"Be brave," Hecker said. "Trust in your own thriving businesses and leadership to develop their potential so they will want to stay with you. We have a tremendous amount of collective knowledge amongst us to transfer to a new generation. Only when that's done will our legacies be complete."

She concluded, "Our business is now and always has been about the people. The best way for us to protect it is to invest in our people to their full potential and engagement together. I, for one, look forward to the journey."

Hecker is happy to report that evening she had four surety company executives come to her and each committed to nominate several employees for the new committee, with several others following suit since the Annual Meeting. "I'm very encouraged we're going to provide the platform for the next generation to begin building better relationships with each other, which hopefully will result in many more thriving business opportunities for all."

Limitless opportunities

Hecker knows the year ahead will be a busy one, but her family—husband Jeffrey, daughter Stephanie and two grandchildren, Morgan and Devin—are accustomed to her hectic schedule. Hecker is a charter member of the CFMA and a member of the Beavers, a heavy engineering construction association.

Hecker with, from left, William Painter, Cory Bentley and Joshua Etemadi

Hecker serving as a panelist at the 2014 NASBP Annual Meeting

Hecker is a Producer Advisory Board Member for Liberty Mutual Surety and regularly writes articles, speaks to construction industry groups and represents the surety industry on panel discussions.

As an 11-year breast cancer survivor, Hecker knows how to overcome obstacles to reach her goals. She sees the surety industry as offering many opportunities for success for people who are willing to work hard at achieving their own objectives.

"There are no limitations on what you can do or where you can go," Hecker said. "Whether you're a young man or a young woman, it's a wonderful industry with a lot of opportunity." ●

Feature

DEVELOPING Your Leadership Vision

BY RICK CIULLO

"WHAT DO YOU stand for as a leader?" The teacher's question rang in my ears during the workshop and kept running through my head for months afterwards. I didn't have a very good answer, and, when I really thought about it, I didn't truly understand the question or its purpose.

Today, I understand the question and its purpose very well, and I even have developed an answer. My answer helps me lead my team with confidence and provides my team with some certainty about the type of environment in which we operate.

Understanding what you stand for as a leader requires that you first understand what you stand for as an individual. What are your core values? What do you care about the most? This might require some soul searching. For most leaders, you can probably look outside your office and see two or three very competent people who could be doing your job. So why should you be chosen to lead? I believe it takes more than just the skills and accomplishments listed on your resume to be a leader.

Every leader has a vision, which, over time, will drive different outcomes for the team. After you've served in a leadership role for several years, your organization will reflect your vision; it will not be the same as it would have been had the company chosen one of those other competent people to lead the team. If vision is so important, then how can you develop yours?

Understand your values

A leader's vision is best understood when discussed in the context of values. Leaders have values, and they make decisions that align with those values.

Think about what is important to you and how it became important. What set of experiences has most influenced you? What do you want to emphasize in your role as leader? If you compared your top five priorities with those of other people who could do your job, you'd most likely find that your top two priorities are the same, but the rest are probably quite different. It's those differences that are going to establish the unique pace and direction for your organization under your leadership.

As I began to explore what I stood for as a leader, it was clear to me that my top two priorities were growing profits and serving clients; but I identified additional priorities that would ultimately set me apart from other leaders–growing talent and establishing successful teams.

My best experiences in life had been as a member of a team. I didn't have to lead the team; I got great satisfaction from being a part of a team that grew and achieved together. Once I felt confident in this priority, I focused on building teams and helping others achieve their full potential as well as growing profits and providing great client service. My vision was to make Chubb Surety richer in talent and in team spirit because of my leadership.

Moving visions into the real world

Simply having a vision is not enough, of course. The first step in translating your vision into action is to be crystal clear about what that vision is and to be comfortable with it. Talk about your vision with others. Express your vision in terms of your values; put it into the context of the greater good of the organization. How will following your vision benefit the company, its employees and its customers?

UNDERSTANDING WHAT YOU STAND FOR AS A LEADER REQUIRES THAT YOU FIRST UNDERSTAND WHAT YOU STAND FOR AS AN INDIVIDUAL.

This is the second part of a two-part article on leadership skills as a lead-in to the NASBP Executive Leadership Conference, titled "Developing Executive Leadership: Style, Vision, Voice & Action." The NASBP Conference will be held in Nashville, Tenn., on October 22, 2015, one day before the NASBP Mid-Year Meeting takes place. For more information about the NASBP Executive Leadership Conference, visit www.nasbp.org.

THE FIRST STEP IN TRANSLATING YOUR VISION INTO ACTION IS TO BE CRYSTAL CLEAR ABOUT WHAT THAT VISION IS AND TO BE COMFORTABLE WITH IT.

Next, identify specific actions you can take to give life to your vision. In my case, that began with re-energizing our trainee hiring programs and re-focusing on succession planning and career development for our top talent. For someone else, it could be introducing a new customer service program or upgrading technology to improve efficiency. Different leaders have different values and visions for their organization.

Understand that along the way you'll be called upon to make some tough decisions to support your vision. For instance, to invest in talent and teams, I had to forego other worthwhile investments, and I had to give people stretch assignments they may not have been 100 percent ready to undertake. Making and executing a plan are important, but the real challenge is making day-to-day decisions in ways that are consistent with your vision.

Building alignment

Talking about your values and making visible decisions to support your vision helps achieve buy-in from your team members. It creates a consistent environment so others can make decisions that help further drive the vision. It also becomes a kind of natural, self-selection process as people who don't agree with your vision or who don't like your decisions eventually leave your team. Over time, the team becomes better aligned with your values as leader.

Your personal style will play a big role in your success at building alignment. The way you listen and ask questions, your personal work habits, how you manage your network and relationships–they all have a huge impact on the people around you. It's pretty humbling to realize that because you are the leader, no word, comment, action or inaction of yours is insignificant to your team members. Everything you do is magnified.

Your style also impacts the people around you, especially if their own personal styles are different from yours. Recognize that some individuals will have a style different from yours, but do not equate those differences with weakness. Leaders embrace and convey the idea that a healthy team is made up of people with different personal styles.

While it's desirable to have different personal styles, it's harmful if people on the team don't buy into the leader's visions. Some team members who don't agree with you may leave, while others may need to be removed from the team. Healthy teams debate about tactics and strategies, not about values and vision.

Leader's right to choose

As a leader, it's generally not your role to execute the day-to-day activities, but rather to set the direction and pace of your team—where you are going and how quickly. You'll have to make tactical decisions (how will I prioritize time?), strategic decisions (where do I invest resources?) and talent decisions (who will I choose for that next big job?). Decisions regarding talent—their skills and competencies—may be among the most important and impactful that a leader must make. Staying aligned with your values and vision can ease any doubt about making these and other challenging decisions.

Finding your voice, style and vision is not a simple task. But those who are willing to work hard to understand their values and how to turn them into their vision have made the first step toward becoming a leader. How well you can communicate that vision while embracing differences and building alignment may determine if you are a successful leader.

If you missed the first part of this article, be sure to read it in the Spring 2015 issue of *Surety Bond Quarterly* on pages 16 and 17.

Rick Ciullo is Chief Operating Officer of Chubb Surety in Warren, NJ, where he oversees Chubb's worldwide surety business. Ciullo can be reached at rciullo@chubb.com or 908.903.5555.

Feature

Can Public Owners be Held Liable to **Subcontractors** and **Suppliers** for Failure to Require General Contractors to Obtain Required **Payment Bonds**?

BY TODD REGAN

IT'S A TROUBLING scenario. After months of promises from the general contractor that payment would be issued soon, that it is about to negotiate a large change order with the owner, and that "they haven't been paid yet either," the subcontractor simply can't wait any longer. The subcontractor has been financing the project for months by paying its own employees and suppliers, without receiving the continually promised progress payments. Finally, the subcontractor asks the owner's representative for a copy of the payment bond, only to hear something it never even considered: the general contractor never posted the payment bond required by law. To make matters worse, because it's a municipal project, it doesn't have the right to file a mechanic's lien; and the prime contractor is heading towards bankruptcy.

Unfortunately, subcontractors do find themselves in this predicament. Despite the requirements of the federal Miller Act, 40 U.S.C. § 3131, *et seq.*, and the similar state laws, the statutorily required payment bonds are not always in place. Perhaps the school board failed to appreciate that the project was subject to the statutory bonding requirements. Perhaps the city council neglected to check if the prime contractor actually submitted the required bonds. Perhaps the contracting officer failed to ensure that the bond was issued by a licensed surety authorized to do business in the state. Perhaps the surety became insolvent after the project started and the owner failed to require a new bond. Regardless of the reason, subcontractors might perform work on public projects with the assumption that their right to payment is secured, only to find out too late – after the prime contractor defaults on its payment obligations – that there is no payment bond in place. What then is the unpaid subcontractor's remedy?

Bond producers and other surety professionals should take note that, under certain circumstances, subcontractors and suppliers may have a right of recovery directly against the public owner for failing to ensure that the required payment bond is posted. Whether the subcontractor has such a right of recovery, or whether it is left out in the cold, varies widely across jurisdictions.

The issue of whether to allow a subcontractor to hold a public owner directly liable for failing to require a payment bond invokes a conflict between two fundamental principles underlying the statutory bonding requirements: protecting the payment rights of subcontractors and suppliers performing public work versus protecting the public coffers from claims for payment. A rule imposing liability on public owners for failing to ensure that the required bonding is in place has the dual benefit of protecting subcontractors and giving public

owners an added incentive to ensure compliance with the bonding requirements. Without question, it is the public owners, and not the subcontractors, that are in the best position to ensure that contractors comply with the bonding requirements. Yet, as set forth in the 50-state survey chart accompanying this article, the majority of jurisdictions do not recognize such a cause of action.

No remedy for the "hapless subcontractor" on federal projects

A subcontractor on a federal Miller Act project has no recourse against the federal government in the event that the required payment bond is not posted. In *Arvanis v. Noslo Engineering Consultants, Inc.*, 739 F.2d 1287 (7th Cir. 1984), *cert. denied*, 496 U.S. 191 (1985), two unpaid subcontractors brought suit against the federal government after the prime contractor, who failed to post a Miller Act payment bond, went into bankruptcy. In dismissing the subcontractors' claims, the court ruled that the federal government has no affirmative obligation to ensure that a prime contractor obtains the payment and performance bonds required by the Miller Act. The court further held that the claims were barred by the government's sovereign immunity. The court noted, with a tangible sense of disappointment, that it is the "hapless subcontractor" and not the federal government that is left "holding the bag" when a prime contractor fails to obtain the required bonding. Although the court recognized that the outcome was "unjust," it noted that it was up to Congress to address the issue by amending the statute.

Significantly, although the court in *Arvanis* advises subcontractors to protect themselves by inquiring with the contracting officers to ensure that the required bonds have been posted, under the statutory language of the Miller Act, in order to obtain a certified copy of the payment bond, the subcontractor must first submit an affidavit to the government certifying that it has not been paid for its work, which may be far too late. *See* U.S.C. § 3133(a). However, subcontractors and suppliers should take note that the Federal Acquisition Regulations provide methods for subcontractors and prospective subcontractors to obtain information about the payment bond posted by the prime contractor as well as a copy of the bond itself prior to entering into the subcontract or performing work on the project. The regulations provide that the contracting officer must furnish this information to subcontractors or prospective subcontractors on request. FAR 28.106-6(b). The regulations similarly require a prime contractor to provide "a prospective subcontractor or supplier offering to furnish labor or material" with a copy of its payment bond upon request. FAR 52.228-12.

Accordingly, subcontractors and suppliers on federal projects are well advised to use these tools to obtain a copy of the prime contractor's payment bond prior to executing a subcontract for the project, rather than waiting until payment disputes arise.

Differing approaches by the states

A subcontractor's ability to assert a claim for payment directly against a public owner for failing to require the prime contractor to post a statutorily required payment bond varies widely from state to state. In a small minority of jurisdictions, a public entity's liability for failing to require bonds is set forth expressly by statute. For example, in Connecticut, a subcontractor is expressly authorized by statute to bring suit for payment directly against a municipality (but not against the state) for failing to ensure compliance with the bonding requirement. *See* Conn. Gen. Stat. § 49-41(d). Similarly, in Idaho, a public body that fails to ensure compliance with the bonding requirement must, on demand, promptly make payment directly to unpaid subcontractors. *See* Idaho Code Ann. § 54-1928. The potential consequences to a municipality for failing to ensure that payment bonds are posted are even more dire in Missouri. Not only does the statute, Mo. Rev. Stat. § 107.170, create an express duty on public entities to ensure that the required bonds are in place, but also public officials may be held *personally liable* for the claims of unpaid subcontractors if they fail to ensure that bonds are posted. *See Union Pacific R.R. v. St. Louis Marketplace, Ltd. P'ship*, 212 F.3d 386 (8th Cir. 2000) (Mo.).

However, as noted by the Alaska Supreme Court, most courts in states that do not expressly impose liability by statute on the public owners have read the bonding statutes narrowly and have declined to impose liability by implication. *See Imperial Mfg. Ice Cold Coolers, Inc. v. Shannon*, 101 P.3d 627, 632 (Alaska 2004).

In rejecting an implied cause of action against the public entity, the court in *Imperial Mfg.* held that such a rule "would be contrary to the premise on which the Little Miller Act is based, which is that neither the government nor government property may be charged by those with whom the government has no contractual relationship. We believe that if the legislature had intended to impose government liability – in effect as the school district puts it, to require public entities 'to pay twice for a public project' – this intention would have been expressed because it is a significant variation from the existing norm." *Imperial Mfg.,* 101 P.3d at 630. Other courts have refused to impose liability on public owners on the grounds that subcontractors have a means of verifying the existence of the payment bond prior to entering into a subcontract. *See Blanchard v. Burns*, 162 S.W. 63 (Ark. 1913).

In contrast, courts that have recognized an implied cause of action against public owners for failing to require bonds have focused on the importance of protecting the rights of subcontractors and suppliers that are deprived of the right to file mechanic's liens against public property. For example, in *Walt Rankin & Associates v. City of Murieta*, 84 Cal. App. 4th 605 (2000), the California Court of Appeals held that a municipality has a mandatory duty to ensure that payment bonds

50-State Survey on Public Owner Liability to Subcontractors and Suppliers for

ALABAMA
*None
**Medical Clinic Bd. v. Smelley, 408 So. 2d 1203, 1981 (Ala. 1981) (public agency liable for subcontractor's payment claim for failing to require payment bond).

ALASKA
*None
**Imperial Mfg. Ice Cold Coolers, Inc. v. Shannon, 101 P.3d 627, 632 (Alaska 2004) (subcontractor could not sue school district for failing to ensure that bonding requirements of Little Miller Act were met).

ARIZONA
*None
**Flori Corp. v. Yellow Rose Dev. & Constr., Inc., 911 P.2d 546 (Ariz. Ct. App. 1995) (city not liable to unpaid subcontractors for failing to ensure that payment bond from viable surety remained in place for life of the project).

ARKANSAS
*None
**Blanchard v. Burns, 162 S.W. 63 (Ark. 1913) (directors of school district could not be held liable to subcontractor for failing to require payment bond).

CALIFORNIA
*None
**Walt Rankin & Assocs. v. City of Murieta, 84 Cal. App. 4th 605 (2000) (municipality has a mandatory duty to ensure that the payment bond posted by a prime contractor is issued by a sufficient admitted surety licensed in California and, in failing to do so, becomes liable for claims of unpaid subcontractors).

COLORADO
*None
**Newt Olson Lumber Co. v. School Dist., 83 Colo. 272 (1928) (school district not liable to subcontractor for failing to require payment bond).

CONNECTICUT
*Conn. Gen. Stat. § 49-41 (d) (political subdivision of the state liable for payment of subcontractor claims for failure to require contractor to post bond; only applies to municipalities and does not apply to claims against the State).
**York Hill Trap Rock Quarry Co. v. Conn-Strux, Inc., 2012 Conn. Super. LEXIS 375 (Feb. 10, 2012) (statute applies only to municipalities; does not waive the state's sovereign immunity).

DELAWARE
*None
**None

FLORIDA
*None
**Palm Beach County v. Trinity Indus., 661 So. 2d 942 (Fla. Dist. Ct. App. 1995) (bonding statute interpreted to impose implied obligation on public entity to ensure compliance with contractor's bond requirement; county directly liable for payment of subcontractor due to its failure to require a bond).

GEORGIA
*Ga. Code Ann. § 13-10-61 (public entity liable for payment of unpaid subcontractors in the event that it fails to ensure that general contractor posts required bond).
**City of Atlanta v. United Elec. Co., 414 S.E.2d 251 (Ga. Ct. App. 1991) (City of Atlanta has been held liable to an unpaid subcontractor for failing to require a payment bond from a general contractor, as provided by statute).

HAWAII
*None
**None

IDAHO
*Idaho Code Ann. § 54-1928 (any public body subject to the act that fails or neglects to obtain the required payment bond must, upon demand, itself promptly make payment to all persons who supplied materials or performed labor in the prosecution of the work under the contract).
**H-K Contractors v. Firth, 101 Idaho 224 (1979) (court affirmed summary judgment in favor of subcontractor's claim against city for failure to require prime contractor to post payment bond).

ILLINOIS
*None
**Western Waterproofing Co. v. Springfield Hous. Auth., 669 F. Supp. 901, 902 (C.D. Ill. 1987) (subcontractor successfully sued public entity for failure to require prime contractor to post required payment bond, on a third-party beneficiary theory).

INDIANA
*None
**None

IOWA
*None
**Star Equip., Ltd. v. State, 843 N.W.2d 446 (Iowa 2014) (when public entity waives bonding requirement for small businesses, unpaid subcontractors can, in the absence of a payment bond, recover directly against the public entity).

KANSAS
*None
**Freeman v. Chanute, 63 Kan. 573, 578 (1901) (public entity cannot be sued by unpaid subcontractor for failure to require bond).

KENTUCKY
*None
**None

LOUISIANA
*None
**None

MAINE
*None
**None

MARYLAND
*None
**Bd. of Educ. v. Alcrymat Corp. of America, 258 Md. 508 (1970) (school board protected by doctrine of sovereign immunity from subcontractor's suit for failure to require payment bond).

MASSACHUSETTS
*None
**None

MICHIGAN
*None
**ABC Supply Co. v. City of River Rouge, 216 Mich. App. 396 (1996) (public entity cannot be sued by subcontractor for failing to require bond or failing to ensure bond remains in place, but if public entity furnishes subcontractor with a certified copy, it is liable to the subcontractor if the bond later is determined to be invalid).

MINNESOTA
*Minn. Stat. § 574.29 (public body liable for payment of subcontractors if it fails to require contractor to post payment bond).
**Green Elec. Sys., Inc. v. Metro. Airports Comm'n, 486 N.W.2d 819 (Minn. Ct. App. 1992) (Metropolitan Airport Commission liable to subcontractor for failure to require payment bond if subcontractor can establish that general contractor was insolvent and unable to pay subcontractor for its work).

MISSISSIPPI
*None
**Mississippi State Bldg. Comm'n v. S & S Moving, Inc., 475 So. 2d 159 (Miss. 1985) (when state failed to require contractor to post bond as called for in contract, unpaid subcontractors could maintain action for payment directly against state when contractor became insolvent; by entering into contract the state waived sovereign immunity); but see Pidgeon Thomas Iron Co. v. Leflore County, 135 Miss. 155 (1924) (subcontractor's negligence claim against public entity for failure to require payment bond barred by the doctrine of sovereign immunity).

MISSOURI
*Mo. Rev. Stat. § 107.170 (all public entities have a duty to ensure that the required bonds are posted; permits public entities to indemnify any of its officers and employees from personal liability for failure to comply with the statute).
**Union Pac. R.R. v. St. Louis Marketplace, 212 F.3d 386 (8th Cir. 2000) (Mo.) (unpaid contractor could maintain action against city as well as individual city officials personally for failing to require developer to post required bonds).

MONTANA
*Mont. Code Ann. § 18-2-202 (public entity liable for payment of subcontractors if it fails to ensure required payment bond

are issued by a sufficient surety that is licensed in California and, in failing to do so, becomes liable for the claims of unpaid subcontractors. In *Rankin*, a city awarded a contract for the construction of a playground to a general contractor that posted a payment bond issued by a Turks and Caicos company not licensed as a surety in California. When the general contractor defaulted on its payment obligations to a subcontractor, the subcontractor asserted a payment bond claim. Unfortunately, shortly after issuing the bond for the project, the president of the surety was indicted, the surety vacated its offices, and its assets were unknown or nonexistent at the time of the lawsuit. The subcontractor then brought suit against the city for negligently failing to require a bond posted by a sufficient surety. The court found an implied obligation on the part of the public owner to investigate and verify the sufficiency of the surety, despite the lack of an express statutory obligation to do so. In the aftermath of this decision, the legislature passed a statute, Cal. Code Civ. Proc.

is posted).
**None

NEBRASKA
*None
**Chicago Lumber Co. v. Sch. Dist. No. 71, 227 Neb. 355 (1988) (subcontractor could maintain a negligence action against school district for failure to require payment bond).

NEVADA
*None
**Charlie Brown Constr. Co. v. Boulder City, 106 Nev. 497 (1990) (subcontractor could sue municipality for failing to require payment bond required by municipal code).

NEW HAMPSHIRE
*None
**None

NEW JERSEY
*None
**None

NEW MEXICO
*None
**None

NEW YORK
*None
**Davidson Pipe Supply Co. v. Wyoming County Indus. Dev. Agency, 85 N.Y.2d 281 (1995) (overturning decision of the trial court holding an industrial development agency was liable to unpaid subcontractor for failure to ensure posting of bond required by State Finance Law § 137, on grounds that the project was not a "public improvement" within the meaning of the bonding statute; leaves open the possibility of a private cause of action against a public owner for failure to require a bond); Murnane Assocs. v. Harrison Garage Parking Corp., 239 A.D.2d 882 (N.Y. App. Div. 1997) (similar holding based on finding that the project was not a public improvement; does not address lower court's finding that the statute provides an implied right of action against the public owner for failure to require a bond).

NORTH CAROLINA
*N.C. Gen. Stat. § 44A-32 (each contracting body shall designate an official to require the bonds described by the Article; if the official designated fails to require the bond, he will be guilty of a Class 1 misdemeanor).
**James River Equip., Inc v. Tharpe's Excavating, Inc., 179 N.C. App. 336, 345 (2006) (unpaid supplier had no cause of action against county board of education for failing to require prime contractor to post replacement bond when original surety became insolvent, although the Little Miller Act does require the public entity to ensure that bonding remains in place throughout the life of the project; the statute only provides a misdemeanor criminal penalty and does not create a private civil cause of action in favor of unpaid subcontractors or suppliers).

NORTH DAKOTA
*None
**None

OHIO
*None
**Ray v. Buel, 50 Ohio App. 525 (1935) (town board of trustees could not be held liable for failure to require payment bond); Art's Rental Equip., Inc. v. Bear Creek Constr. LLC, 2010 Ohio Misc. LEXIS 531 (Mar. 16, 2010) (Port Authority not obligated by statute to require bonds; even if statute did require bonds, there would be no private right of action against a public entity for failure to comply with the statute).

OKLAHOMA
*None
**Boren v. Thompson & Assocs., 2000 OK 3 (2000) (absent an express statutory provision, a school board cannot be held liable to an unpaid subcontractor for failure to ensure that statutorily required bonds are posted; but project architect hired by town to design the project and oversee construction can be held liable to subcontractor for approving release of progress payments to prime contractor without ensuring that required bonds had been posted).

OREGON
*Or. Rev. Stat. § 279C.625 (State of Oregon or the public body and the officers authorizing the contract shall be jointly liable for the labor and materials used in the performance of the work for failure to require posting of payment bond).
**Platt Elec. Supply, Inc. v. JC Northwest, Inc., 159 Ore. App. 328 (1999) (public housing authority liable to unpaid subcontractor for failure to require payment bond).

PENNSYLVANIA
*None
**Cassady-Pierce Co. v. Spagnol, 160 Pa. Commw. 666 (1993) (court will not read an implied private right of action against public entity for failure to require a bond if it is not expressly stated in the statute).

RHODE ISLAND
*None
**Accent Store Design v. Marathon House, 674 A.2d 1223 (R.I. 1996) (public entity has no liability for failing to ensure that prime contractor posts bonds).

SOUTH CAROLINA
*None
**Shirley's Iron Works, Inc. v. City of Union, 403 S.C. 560, 574 (2013) (unpaid subcontractor may sue city for failure to require payment bond under a third-party beneficiary breach of contract theory; city's liability is limited to unpaid contract balances at the time it received notice of subcontractor's claim; city's obligation is only to ensure that bond is posted; it is not obligated to ensure that a viable bond stays in place for the life of the project).

SOUTH DAKOTA
*S.D. Codified Laws § 5-21-2 (public corporation liable to unpaid subcontractors if it fails to ensure that payment bond is posted).
**Pete Lien & Sons v. City of Pierre, 577 N.W.2d 330 (S.D. 1998) (statute did not apply because the project was not public improvement within the scope of the bonding statute).

TENNESSEE
*Tenn. Code Ann. § 12-4-202 (if any public officer, whose duty it is to award contracts, awards any contract without requiring payment bond in compliance with § 12-4-201, such officer commits a Class C misdemeanor).
**None

TEXAS
*Tex. Gov't Code Ann. § 2253.027 (if a governmental entity fails to obtain from a prime contractor a payment bond, the entity is subject to the same liability that a surety would have if the surety had issued a payment bond and if the entity had obtained the bond).
**None

UTAH
*Utah Code Ann. § 14-1-19 (if the state or a political subdivision fails to obtain a payment bond, it shall, upon demand by a person who has furnished labor or supplied materials to the contractor or subcontractor for the work provided for in a contract subject to § 14-1-18, promptly make payment to that person).
**None

VERMONT
*None
**None

VIRGINIA
*None
**None

WASHINGTON
*Wash. Rev. Code § 39.08.015 (county, incorporated city or town, or other municipal corporation shall be liable to unpaid subcontractors or suppliers for failing to require prime contractor to post bond).
**None

WEST VIRGINIA
*None
**None

WISCONSIN
*None
**Holmen Concrete Prods. Co. v. Hardy Constr. Co., 2004 WI App 165 (Wis. Ct. App. 2004) (municipality liable to unpaid subcontractors for failure to require payment bond).

WYOMING
*None
**None

*Express Statutory Liability for Failure to Require Bond **Potential Liability Addressed by Courts

§ 995.311, which creates a streamlined process for public owners to verify the status of a surety on the website of the State Department of Insurance and provides owners a safe harbor against claims for failure to verify the sufficiency of the surety. Thus, public owners now have a simple way to verify the sufficiency of sureties, and subcontractors and suppliers are protected against the posting of bonds by unlicensed fly-by-night sureties.

Although some jurisdictions have recognized an implied cause of action against public owners for failing to ensure that payment bonds are posted, most have declined to go so far as to conclude that the public owner has an obligation to ensure that a valid payment bond remains in place for the life of the project. In *Flori Corp. v. Yellow Rose Development & Construction*, 911 P.2d 546 (Ariz. Ct. App. 1995), the contractor's surety entered into liquidation during the project and was unable to pay the claims of subcontractors. The court rejected the subcontractors' claims

Continued on page 38

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We unite over 7,500 construction companies across the nation and continue to grow. If your clients' accounting firm doesn't know the construction industry as well as they should, then we can help.

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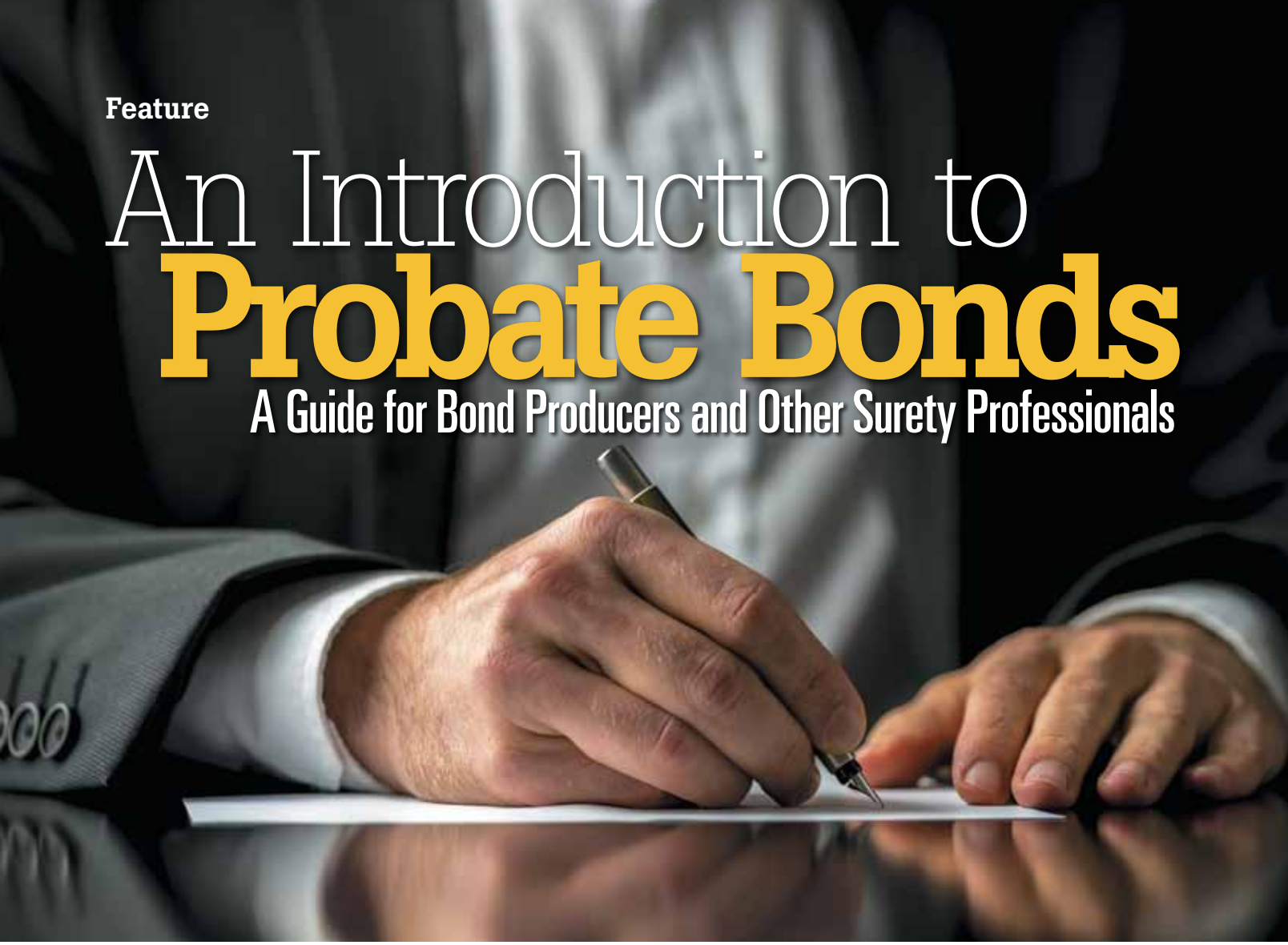
Feature

An Introduction to Probate Bonds

A Guide for Bond Producers and Other Surety Professionals



BY JEFFREY M. FRANK

PROBATE BONDS ARE used to protect the ward in a probate estate, the creditors of the estate, and the heirs of an estate. In some jurisdictions, they are quite common — so common that the courts permit bond producers to have desks at the courthouse to ease the process of obtaining these bonds. In other jurisdictions they are almost a foreign concept and are rarely, if ever, ordered as a condition of a fiduciary qualifying and serving in a probate estate.

Probate bonds are often given very little thought until things go terribly wrong. It is then, in the event that the court requires a bond as a condition for the fiduciary to serve, the true purpose of that bond becomes evident. Bond producers and other surety professionals may not have an in-depth understanding of probate bonds and how they work, unless those producers write a large volume of them. This article is designed to provide a general introduction to and a broad overview of this important commercial surety bond.

What types of probate bonds can a court order?

In order to protect the assets of an estate, courts can order probate bonds in four general situations. In each of these situations, the court appoints a fiduciary, who is a person with special responsibility of managing and protecting someone else's property, to manage a probate estate or trust.

First, there can be a bond to protect the assets of those under a disability. This type of estate is commonly referred to as a guardianship or conservatorship (depending on the jurisdiction). Here, the bond would protect the assets of a minor, such as life insurance proceeds, an inheritance, or the proceeds from a lawsuit, or the assets of a legally incapacitated adult who, for any variety of reasons, is no longer able to manage his or her own assets.

Second, the court can require the personal representative or executor of a decedent's estate to obtain a bond to protect the decedent's assets in a decedent's estate. The personal representative's duties are to collect the assets, pay the decedent's creditors, and then distribute the remaining assets to the heirs.

WHEN OBTAINING THE APPLICATION FROM THE NOMINATED FIDUCIARY, THE BOND PRODUCER SHOULD BE SURE TO OBTAIN A SIGNATURE ON THE INDEMNITY AGREEMENT.

Third, the probate court can order a trustee of a trust to obtain a bond. This often happens when a party moves to register an otherwise private trust with the court. Trustee bonds are also becoming more common with the use of Special Needs Trusts, which are special trusts that permit individuals to obtain a lump sum of money (often from a law suit settlement or inheritance) without losing the ability to continue receiving government benefits.

Finally, courts can order bonds in connection with the sale of real estate. These bonds specifically protect the proceeds of the sale of a parcel of real estate until those proceeds are used for their intended purpose, such as payment of creditors, distribution to heirs, and support of the ward.

Probate bonds must almost always be approved by the court. It is critical that the court review the bond and power of attorney to ensure that it is appropriate. If any issues arise, the obligee or principal should not hesitate to immediately contact the surety.

Underwriting/issuing probate bonds

When a court orders a fiduciary to obtain a bond, that fiduciary will have to find a bond producer to issue the bond. In some jurisdictions, there are producers available at desks in the courthouse to make the process simple. In other jurisdictions, the fiduciary may turn to his or her personal insurance provider to obtain the bond. Some agencies have an on-line presence and permit applications over the internet.

The bond producer issuing the bond should be sure to use the surety's Bond Application, which should contain an Indemnity Agreement. Once the producer has obtained the required information from the applicant, the application should be submitted to the surety to ensure that it meets all underwriting requirements. The bond producer should make sure to explain the purpose of the bond to the applicant and should also explain the importance of accounting for all assets of the estate. These explanations at a very early stage in the process can help avoid potential claims down the road. It is critical that fiduciaries understand that they should not engage in cash transactions, that they should write checks for all expenses they pay, and that they should retain all receipts. They should also obtain court approval for any significant or out-of-the-ordinary expenditures.

The producer must also make sure that the fiduciary understands his or her duties, such as filing an Inventory and Annual Accounts with the court. It is important that the fiduciary understands that he or she cannot cancel the bond by failing to pay premiums. The bond can only be cancelled by an order of the court. This means that the surety's exposure, as well as the fiduciary's indemnity obligation, can last the entire time that the fiduciary serves and even beyond that time if the fiduciary's Final Account is not allowed by the court, the fiduciary is not discharged, and the bond is not cancelled.

The bond producer should also evaluate the character and qualifications of the applicant. Producers often develop relationships with attorneys practicing probate law in order to obtain probate bond business from them. While the attorneys may be known to the producers, each of their clients should be independently evaluated.

When obtaining the application from the nominated fiduciary, the bond producer should be sure to obtain a signature on the Indemnity Agreement. It is also critical to understand the applicant's prior experience handling estates and serving as a fiduciary, the assets of the estate or trust, and whether the fiduciary's attorney will be involved throughout the duration of the administration of the estate. In fact, some sureties require attorney involvement prior to agreeing to issue the bond. The producer should make sure to obtain a basic understanding of the issues within the estate.

Underwriting considerations

Application

As previously indicated, it is critical that the bond producer obtain the applicant's signature on the Bond Application containing the Indemnity Agreement. In addition, the application should have information regarding the applicant's employer, income, and net worth. In the event of a loss, this will aid in recovery of not only the loss, but also loss adjustment expenses, such as attorneys' fees and costs as well.

The application and underwriting process for a probate bond is different from the process for a performance and payment bond. For example, there are very few documents involved (unless the penal sum of the probate bond is exceptionally large). The surety generally does not review financial statements or balance sheets. At best, the surety will review documents from the probate court file (such as the Inventory, if one has been filed, or an order appointing the fiduciary) and may run a credit report. Because there are few documents involved, the application and the information the producer receives from the principal are critical.

Control of accounts

The bond producer must also determine if the surety will require controls on the estate assets. The controls vary from surety to surety and state to state. They could include joint control of banking or investment accounts with the surety or its authorized agent, joint control of banking or investment accounts with the fiduciary's attorney, court orders that restrict the assets of the

estate, or restrictions on the Letters of Authority issued by the court. Putting one or more of these restrictions in place will not only help limit access to the funds, but also help fiduciaries avoid the temptation of inappropriately accessing and spending the funds.

Attorney involvement

Many sureties require attorneys to be involved from the beginning of the estate administration through the end. Once an attorney makes that commitment, he or she should provide the surety with some assurance that funds will be properly used and that the estate will be properly administered. Some sureties require that the attorney sign an agreement indicating that if he or she withdraws as counsel for the fiduciary, then the attorney will put the surety on notice of the withdrawal. Other sureties require the attorney to exercise joint control over the funds with the client.

Size of estate

The underwriting for a small estate is generally much easier and quicker than for a large estate. Each surety defines "small estate" or "large estate" differently. Because the surety's potential liability is greater once an estate meets the surety's definition of a "large" estate, the underwriting process for a large estate should not be automated; an actual review of all information should be undertaken by the surety.

Penal sum of bond and assets of the estate

The penal sum of the bond is generally based on the value of liquid assets of the estate, personal property owned by the estate, and the ward's annual income. During the underwriting process, the bond producer should have a clear understanding of the assets in the estate. To the extent the penal sum of the bond is inconsistent with information provided to the producer, he or she should follow up with the fiduciary or his or her counsel to obtain more information about the assets.

Co-fiduciaries

In some situations, the court will appoint two individuals to serve as co-fiduciaries. If a surety is willing to write a bond for two fiduciaries, the bond producer should obtain a bond application with a signed indemnity agreement from each of those fiduciaries. The producer should ensure that the surety issues a single bond in the penal amount ordered by the court as opposed to two separate bonds (one for each co-fiduciary). The issuance of two separate bonds could lead to double the exposure for the surety.

Underwriting red flags

Each surety has its own list of "red flags" that create unfavorable risks for the surety. This especially holds true in larger estates. Instead of simply declining to write a bond when a red flag is raised, sureties can attempt to underwrite the risk by obtaining more information or putting a system of controls in place.

While each surety may treat red flags differently, the following is a list of typical red flags:

1. The nominated fiduciary is not represented by an attorney.
2. The applicant is not qualified to serve as bond principal.
3. The surety is being asked to issue a bond in an estate that is in the midst of being administered.
4. There are disputes between family members and heirs (especially those that are being litigated).
5. The fiduciary is running an ongoing business within the estate.
6. There is a substantial lapse of time between the date of death and the appointment of the fiduciary to administer the estate.
7. There is a high penal sum without appropriate controls of estate assets in place. (Each surety has its own threshold for a large bond.)
8. The fiduciary has long-term financial obligations.

Claimants on a bond

After the underwriting process is completed, the surety will issue a bond naming the fiduciary as principal. From this point forward, this article will refer to the fiduciary as the principal.

There are generally five types of potential claimants on probate bonds:

1. First, a successor fiduciary who takes over an estate after the principal has resigned, been suspended, been removed, or has died can bring a claim against the principal and its surety.
2. A devisee/beneficiary/heir can bring a claim, especially in situations where his or her interest in the estate is affected by the acts of the principal.
3. A creditor (to whom the estate is indebted) can bring a claim, especially when estate funds have been used inappropriately by the principal, leaving an estate unable to pay a legitimate creditor.
4. An outside third party can bring a claim against a principal based on the breach of an agreement, contract, or in other situations.
5. Finally, a ward can bring a claim against the principal if he or she reaches the age of majority and learns that the estate has been mishandled or if an adult is restored to competency and learns that the principal breached his or her fiduciary duties.

Types of claims and damages

When a nominated fiduciary eventually qualifies as the estate's fiduciary/surety's principal, he or she will have to file an Inventory with the court. An Inventory is a document that sets forth the items in the estate and the value of those items. Principals must also file an Annual Accounting with the court, which itemizes all income and expenses of the estate, as well as the balance remaining, at the end of each accounting period. Often, the failure to file an Inventory or Accounting or the failure of a court to allow an Accounting can lead to a surcharge against the surety.

A surcharge against a surety is, essentially, a judgment against the surety based on the inappropriate action of the principal and the principal's obligation to pay the estate or trust. A successor fiduciary or other interested party can file a Petition to Surcharge against the principal and surety (discussed later). This is similar to a surety being required to satisfy a payment bond claim because the principal has a payment obligation that he or she has failed to fulfill and the surety has no applicable surety defenses to assert.

There are a number of other situations that can lead to a surcharge as well. Those situations include, but are not limited to, the following:

1. The principal's failure to properly marshal assets (collect the estate's assets).
2. Inappropriate expenditures by the principal (often not for the benefit of the ward).
3. A decrease in value of assets held by the estate, often securities, when they should have been sold.

4. Failure to properly run a business owned by the estate.
5. Self-dealing or conflict of interest when the principal acts in his or her own interest instead of the interest of the estate.
6. Attorneys' fees and costs incurred in pursuing a claim against the principal and surety.
7. Reliance on counsel (often when a principal gets bad advice from his or her attorney when administering the estate).
8. Failure to file or pay taxes (resulting in interest and penalties owed by the estate).
9. Theft of assets from the estate.
10. Failure to maintain insurance on assets owned by the estate (resulting in a claim if there is, for example, a fire and an uninsured house owned by the estate burns).
11. Failure to collect rent from tenants living in property owned by the estate.
12. Inappropriate charitable contributions.
13. Inappropriate settlement of a claim (often when the settlement is not approved by the court or not in the best interest of the estate).
14. Excess bond premiums (often when the fiduciary fails to timely complete the administration of the estate, which keeps it open longer than necessary, causing the estate to incur additional expenses).

A practical guide to handling probate bond claims

In the unfortunate situation when a formal claim is brought against a probate bond, the claims handler or attorney defending the claim will conduct an initial review of all available materials in the file. It is critical that the bond producers and underwriters obtain and provide as much information as possible at the time the bond is issued. Not only will the claim handler review any correspondence or pleadings received to initiate the claim, but the claim handler will want to review the surety's internal records, especially the underwriting file. This file should have detailed information regarding the assets of the estate, as well as detailed information regarding the principal, including an address, phone number, employer, and social security number.

The claims handler will then review the court docket and the probate court file. This will provide a chronology of everything that took place from the time the bond was issued to the present. It is important to determine if the alleged wrongdoing took place prior to or after the bond was issued because, in some jurisdictions, sureties are not liable for wrongdoings that occurred before the bond was issued.

As a practical matter, the claim handler or attorney will attempt to resolve the matter before a formal Petition to Surcharge is filed. A Petition to Surcharge is like a lawsuit against the principal and surety, seeking to obtain a judgment or order to pay against the surety based on the wrongdoings of the principal.

In some situations, the surety might insist that an Order Resolving the Surcharge is entered once the parties have settled the claim. This is often because the Order will include language that will permit the bond to be canceled and the surety to be released from any further liability once the surcharge is satisfied.

Conclusion

The information in this article should help producers understand the importance of obtaining pertinent information about the principal and assets of the estate prior to issuing probate bonds because that is when the principal is most willing to provide information due to the fact that he or she needs the bond in order to qualify as the estate's fiduciary. Any information relating to the principal is extremely useful in the unfortunate event that a bond claim arises.

If a producer has any questions regarding the issuance of the bond, he or she is encouraged to make contact with the surety's underwriting department to ensure all of the necessary pieces of information are in place prior to issuing the bond.

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CLASS ACT

Surety Team's Cooperative Efforts Enable School to Open on Time

WHEN A SUBCONTRACTOR is unable to complete a construction project, the relationship between the sub's bonding company and the job's general contractor can start out strained and go downhill from there. In some cases their disagreements develop into a battle that ends up in prolonged litigation.

But there are exceptional projects when all of the interested parties pull together to turn a potential disaster into an unqualified success. During the construction of the new Gaithersburg High School in Maryland, the active role played by the agency, Insurance Associates, Inc., and the surety, The Hartford, facilitated a speedy resolution of a subcontractor default.

Warning signs

HESS Construction began building the 420,000-square-foot Gaithersburg High School in the summer of 2011, with completion required by the first day of school in August 2013. The mechanical subcontractor was C&H Mechanical. Although construction manager HESS had some reservations about C&H, it was obliged to accept low bidder C&H because C&H was pre-approved by the client, Montgomery County Public Schools.

Insurance Associates had a double interest in the project. It was the bonding agent for HESS, and, because it had acquired the agency that originally wrote the surety bond through The Hartford, for C&H Mechanical as well.

The first indication of trouble came with C&H's inability to maintain adequate manpower on the job to remain on schedule. In the fall of 2012, Insurance Associates learned that suppliers hadn't received payment from C&H for previous equipment deliveries to the job site and that the vendors were refusing to ship anything more until they were paid.

"That brought everything to a head," said Stephen A. Spencer, President of Insurance Associates, which is based in Rockville, Maryland. "C&H came to us, trying to tell us that they were fine, but we knew things were not going well." After a meeting with C&H, HESS and Montgomery County Public Schools, Insurance Associates advised the mechanical contractor to contact The Hartford.

"Because of our relationship with HESS, we wanted to make sure that things went as smoothly as possible," Spencer continued. "We asked The Hartford to jump on this very quickly. Many times in these processes there are a lot of letters back and forth, and it takes a while. But in this case the school had to be open at a certain time, so we facilitated meetings with C&H, HESS, Montgomery County Schools and The Hartford."

Fast response

The Hartford had already been keeping an eye on C&H's finances. "Prior to C&H reaching out to us in early November 2012, our underwriting office, concerned about the

Steve Spencer, left, and Aldo Pasquariello of the NASBP Member firm Insurance Associates.

company's financials, had required that the project be put into an escrow account process," said Gary Judd, Director of Claim Management. The money HESS paid to C&H went into the escrow, but it soon became apparent that the available funds would not be enough to settle the past-due bills and maintain payroll.

The situation was unusual, however, because C&H, at the urging of Insurance Associates, didn't wait for vendors or HESS to file a claim before contacting The Hartford.

"Typically, when a claim comes from a vendor, there's a lot of

exchange back and forth, and it can take time to figure out what is owed that vendor or supplier. Because C&H came to us, it streamlined the process substantially," said Judd.

The Hartford soon determined that C&H did not have the resources to complete the project successfully and would have to be replaced. But HESS had several concerns about how this would impact the project.

"Sometimes you have a surety that doesn't want to respond or is very slow in responding, and the project gets harmed," said Chris Carpenito, HESS Executive Vice President and CFO. "Or the surety company wants to replace the contractor with whoever has the lowest price and that subcontractor has problems, too. But this is our premier client, and it was a very high profile school for them. We could not allow that to happen."

In fact, that did not happen at Gaithersburg High School, thanks to the concerted efforts of The Hartford and of Insurance Associates, which took part in many of the meetings between HESS and the surety.

The Hartford staff worked through the end-of-year holidays that year to request and evaluate proposals from three subcontractors. Judd said that Insurance Associates provided valuable background knowledge about the viability of the various subcontractors during this process.

In early January 2013 The Hartford selected Shapiro & Duncan and agreed to a cost-plus-fee arrangement to accelerate the work and to avoid any financial penalties it might have to pay if the school wasn't ready on time.

"Based on the strength of Shapiro & Duncan's proposal, we were confident in their ability to see the project through to completion," said Judd. "We also knew that HESS and Shapiro & Duncan had a good working relationship from prior projects, which would help this project proceed smoothly."

Back on track

Shapiro & Duncan signed a letter of intent with The Hartford on January 14 and mobilized on site January 21.

"We had determined that the work was about 35 percent complete when it should have been in the 70 percent range," said Mark Drury, Shapiro & Duncan's Vice President of Business Development. Because The Hartford got the new mechanical contractor on site so quickly, the project team was able to prevent any problems with poor workmanship by workers from the company being replaced. The

Hartford's quick payment of funds for the subcontracted portions of the work also helped Shapiro & Duncan catch up.

"We had 60 men on the job the first week to try to get things straightened out," said Drury. "There were a lot of long days and weekends, and we topped out at 85 people on the site. By the end of March we were pretty much caught up and pushing the job."

HESS completed the Gaithersburg High School on time, and the school opened to students at the start of the new school year in August 2013. Its client, Montgomery County Public Schools, was pleased with the project's results.

"Having problems with a $12-$13 million mechanical package smack in the middle of a critical path had all the elements of a catastrophe as far as schedule and HESS' relationship with the client," said Carpenito. "Insurance Associates was working with The Hartford and explaining to them very clearly what the risks were."

"We recognized the urgency and were able to expedite the rebidding process to bring a new subcontractor on board in a very short time," said Judd.

"A month or two after the replacement was completed, you'd forget it even happened. That's almost never the case. You're usually struggling the whole rest of the job because of the impact that a critical path default has on the overall project," said Carpenito.

"We were very pleased with Insurance Associates, with The Hartford and with the overall outcome," he added.

The story of Gaithersburg High School demonstrates how a bond producer can work with a surety to help prevent a difficult problem from becoming even worse.

"Even if C&H had been our only client, we would have been able to help, but because HESS is our client as well, we were able to be even more effective," said Aldo Pasquariello, CIC, Insurance Associates Executive Vice President.

"With Steve Spencer going to the meetings, it proved that a bond producer can add significant value in these kinds of situations," he added. "It's not that we're writing checks or making decisions, but it definitely helped to make everybody understand and be aware of what the downside was if things didn't happen the way they needed to happen."

Feature

NASBP Attorney Advisory Council Participants Opine on Current Risk Management Challenges and Business Opportunities

NASBP IS PLEASED to announce an exciting new initiative — the Attorney Advisory Council (AAC). The AAC is comprised of eight lawyers with broad and deep knowledge and experience in various relevant sectors of the industry, including contract surety, commercial surety, construction, and/or government contracts.

The mission statement for the AAC states as follows:

> The NASBP Attorney Advisory Council is constituted for the purpose of serving as a resource team to NASBP and providing substantive content to NASBP for articles, programs, and presentations on surety, government contracts, and construction law topics for the betterment of the surety industry.

The distinguished attorneys who serve on the Attorney Advisory Council comprise a valuable NASBP "resource team." These lawyers will provide articles for the various NASBP publications, including *Pipeline* and *Surety Bond Quarterly*; participate in NASBP Virtual Seminars; develop articles for SuretyLearn.org; assist with the development of various online courses; and provide in-person presentations on various topics at the Annual Meeting, Regional Meetings, and special conferences and seminars.

As a brief introduction to the attorneys serving on the AAC, each attorney responds below to a question posed on a current, compelling topic of interest to surety professionals and their contractors and subcontractors.

Barron Avery
Baker & Hostetler LLP
Washington, DC

Q What should federal construction contractors be most concerned about in the coming year?

Answer: Compliance plans. Federal construction contracts require contractors to maintain numerous compliance plans, such as business and ethics compliance plans, anti-human trafficking compliance plans, and government property management plans. A federal contractor's failure to maintain adequate compliance plans could place the contractor at risk for a civil False Claims Act (FCA) suit and other negative consequences. With the noticeable uptick in FCA enforcement over the past few years, adequate compliance plans are more important than ever. Federal construction contractors should therefore ensure that their compliance plans meet contractual requirements, and a regularly scheduled "check-up" of those compliance plans will go a long way to mitigating contractors' FCA risk.

Adrian Bastianelli
Peckar & Abramson, PC
Washington, DC

Q How will increased fraud enforcement impact sureties?

Answer: The government has dramatically increased the vigor with which it pursues fraud and false claims in construction contracting. Generally, a surety will not be responsible for its principal's fraud or false claims unless the surety participated in the fraud or conspired with the principal. The mere fact that the surety issued bonds for a principal that submitted a false claim should not trigger liability.

A completing surety, however, is not in the same situation. The surety will be responsible for false or fraudulent claims it submits. Some sureties do not understand their obligations and might be ill equipped to avoid the pitfalls in pursuing payment from the government. As a result, the completing surety needs to carefully review its claims and payment demands to ensure that there is a factual and legal basis and that the claimed costs are allowable, allocable, and reasonable. It cannot blindly rely on its principal. Failure to perform such a review can expose the surety to significant liability.

Jeff Frank
Alber Crafton, PSC
Troy, MI

Q What can we expect in the world of commercial surety in the next few years?

Answer: According to the Wells Fargo 2015 Insurance Market Outlook, fierce underwriting competition, too many carriers, and insufficient client need will result in continued softening of rates.

Premium is down in construction surety. As a result, a number of new carriers have entered the commercial surety market. Because there is already excess capacity in that market, the new carriers may only stay in this market for the next one to two years. In addition, it is questionable if there is sufficient need in the commercial surety marketplace to generate sufficient revenue for these carriers. They may choose to return to the contract surety market as the need there increases. There is also currently more market capacity available than there is client demand for commercial surety.

As a result of the increased competition, underwriting has softened. There is some concern that the looser underwriting will ultimately lead to an increase in claims. Finally, pricing has continued to soften as competition increases.

Keith Langley
Langley LLP
Dallas, TX

Q Can a surety that justifiably relies on an audit bring a cause of action against the CPA for negligent misrepresentation?

Answer: In some jurisdictions, such as Texas, an intended third party, such as a surety, justifiably relying on an audit, can bring a cause of action against a certified public accountant (CPA) for negligent misrepresentation. The CPA auditing a construction company holds herself or himself out to have a particular knowledge and expertise with construction accounting. The surety relies on the CPA to be independent; maintain professional skepticism; understand and test the internal controls of the contractor; and to evaluate, analyze, and test key issues.

The applicable accounting standards require an auditor to ensure the validity of the numbers in a company's financial statements. The failure of the auditor to do so can negatively impact an underwriting surety that relies on the audit. Whether a surety has the right to rely on the audit and the right to sue if an audit is negligently performed is jurisdiction specific.

Mike Pipkin
Sedgwick LLP
Dallas, TX

Q In the current economic environment, how can a contractor's banking relationship help it grow into different markets?

Answer: A principal should have a wide range of financial and credit facilities in place, in addition to its bonding capacity, including an operational line of credit with its primary bank, plus equipment and inventory financing, with such lending secured in a variety of ways. While intercreditor agreements are often used by sureties when financing of the principal is determined to be the best approach to mitigate a loss, they can also be used during the underwriting process, when a principal is evaluating new opportunities. In those situations, carefully negotiated and drafted intercreditor agreements, with the surety and lenders acknowledging and consenting to each other's rights in specific collateral, can enable a principal to approach new business opportunities with confidence in its lending and credit relationships. At the same time both the surety and the financial institution can remain secure in their rights and collateral in the event of a claim.

Steve Reed
Smith, Currie & Hancock LLP
Atlanta, GA

Q What is the greatest risk today for federal contractors?

Answer: By far, the greatest risk is claims made against contractors pursuant to the False Claims Act. Such claims can be filed by private parties, known as qui tam relators, on behalf of the government. The cases are filed under seal (that is, secret and unknown to the target defendant contractor). The government (Department of Justice) has a relatively brief time to decide whether to join the case; however, the time limit is routinely extended, again in secret (that is, under sealed court orders) for up to months and years. False claims can be something as straightforward as misclassification of workers under prevailing wage requirements and then filing wage reports that are incorrect (false statement) or submitting an equipment lease cost for equipment owned by an affiliated company in support of a change order proposal (false claim). The intent requirement is general in nature, and the line between an honest mistake and a false claim/statement is fuzzy.

Todd Regan
Robinson & Cole LLP
Hartford, CT

Q What are the three most important risk-shifting contract terms a contractor and its surety should be concerned about?

Answer: "No damages for delay" clauses shift the financial risks of project delays to the contractor. These clauses preclude recovery of increased costs resulting from extended project duration, even when such costs result from owner caused delays. Although there are exceptions to enforcement of these clauses, they are routinely enforced by courts to defeat otherwise meritorious claims.

Although mutual waivers of consequential damages can limit damages a contractor can recover from an owner, they protect the contractor and surety from claims for the owner's lost revenue and other speculative losses due to delayed project completion.

Although many states have "anti-indemnity" statutes that invalidate clauses requiring contractors to indemnify owners for damages caused by the owner's own negligence, contractors are often required to provide broad indemnification to owners from damages arising from their work. Contractors must ensure that their insurance covers the scope of their indemnity obligations.

Armen Shahinian
Chiesa Shahinian & Giantomasi PC
West Orange, NJ

Q Is it sufficient to protect the surety's interests if only the parent company of an account signs the indemnity agreement, where bonds will be issued with its subsidiaries or affiliates as the bond principals?

Answer: The best practice is to require each company on behalf of which bonds are to be issued to sign the indemnity agreement. Some, but not all, indemnity agreements state that each signatory intends to bind its affiliates, but that might not be sufficient to bind the non-signatory companies to the terms of the indemnity agreement. The surety may face interpretational, legal and evidentiary challenges in seeking to establish that the parent company was authorized as an agent to bind its subsidiary. In such a case, a surety's assignment rights, right to settle, access to books and records, collateral deposit, and other rights spelled out in common forms of indemnity agreements may be found to be unenforceable against a bond principal that did not itself sign the indemnity agreement. ●

BY SUSAN VAN BELL

The AIA Describes UPDATED AND EXPANDED DESIGN–BUILD DOCUMENTS FAMILY

IN 2014, THE American Institute of Architects (AIA) released revised versions of its 2004 Design-Build family of documents. Subsequently, the AIA expanded that family with a new residential design-build agreement and payment application forms for use in design-build projects.

Design-build is a process in which the owner contracts directly with one entity to provide both the design and construction of the project. The design-builder may be a design-build entity, an architect, construction contractor, real estate developer, or any person or entity legally permitted to do business as a design-builder in the jurisdiction where the project is located.

The AIA's design-build documents are flexible with respect to the type of entity that performs the design-build services. Along with the owner/design-builder agreement (A141™-2014), there is a design-builder/contractor agreement (A142™-2014) and a design-builder/architect agreement (B143™-2014), either of which may be used, depending on what services are performed by the design-builder. Other agreements in the 2014 design-build family include owner/consultant (C141™-2014), architect/consultant (C441™-2014), and contractor/subcontractor (A441™-2014) agreements. This article focuses primarily on the A141 owner/design-builder agreement.

The AIA made substantial changes in the 2014 design-build documents involving format and substance, including incorporation of the general conditions into the prime agreement between the owner and the design-builder, an expanded exhibit for insurance and bonds, a sustainable projects exhibit, and a more robust design phase.

The 2004 owner/design-builder agreement only required the design-builder to provide minimal design documents prior to preparation of the construction documents. The 2014 owner/design-builder agreement sets forth a detailed process for the pre-construction phase of the project. This more robust process is intended to encourage owners to better consider their project requirements and to enhance collaboration between the owner and design-builder, early on in the process.

The 2014 owner/design-builder agreement requires the owner, upon engaging the design-builder, to provide owner's criteria, such as the owner's program, design requirements, and sustainable objectives. Once established, the owner's criteria become part of the design-build documents and can only be changed by mutual agreement in writing.

The design-builder prepares a preliminary evaluation of the owner's criteria, reviews it with the owner, and then develops a preliminary design. After the preliminary design is approved by the owner, the design-builder develops a proposal that includes the proposed contract sum and contract time. If the owner agrees to the proposal, the Design-Build Amendment (Exhibit A) is executed. This includes a compensation section with check boxes for selection of stipulated sum or cost of the work plus the design-builder's fee, with or without a guaranteed maximum price, as the design-builder's compensation for work performed after execution of the amendment.

Compensation for work performed by the design-builder prior to execution of the design-build amendment is set forth in the owner/design-builder agreement. The design-builder is compensated for work performed prior to execution of the design-build amendment even if the parties do not reach an agreement on the design-builder's proposal and the amendment is not executed.

Construction services are provided in accordance with the terms and conditions set forth in the owner/design-builder agreement. Unlike the 2004 document, which has a separate exhibit for the terms and conditions, A141-2014 contains the terms and conditions in the body of the agreement and they have been updated to be more consistent with those in the A201-2007 (conventional) family of documents. For example, rather than mediation followed by mandatory arbitration, as in the 2004 document, the 2014 document now contains a checkbox section in which the parties select the method of binding dispute resolution between arbitration, litigation in court, or "other."

The 2014 Insurance and Bonds exhibit (Exhibit B) is more

comprehensive than the 2004 exhibit. A141™-2004 had some insurance provisions in the terms and conditions exhibit and some in the insurance and bonds exhibit. For ease of use, the 2014 version contains all of the insurance provisions in Exhibit B. Separate fill points are provided to list required policy limits for each type of insurance. New insurance requirements in 2014 include professional liability and pollution insurance. The exhibit contains a table to list the type and penal sum of performance and payment bonds.

A141-2014 includes a new exhibit for Sustainable Projects (Exhibit C) for use when the owner intends to pursue one or more sustainability goals, referred to as the owner's sustainable objective. Exhibit C is used to identify the scope of the design-builder's sustainability services and the owner's obligations in relation to achieving the sustainable objective. The Sustainable Projects exhibit is derived from the previously published AIA Sustainable Projects Documents.

The format of the A142-2014 Design-Builder/Contractor agreement is similar to the previous edition. The agreement terms are supplemented with exhibits for the terms and conditions (Exhibit A), insurance and bonding provisions (Exhibit B), preconstruction services (Exhibit C), and determination of the cost of the work (Exhibit D). A142-2014 was also generally updated to be more consistent with current AIA Contract Documents language.

The new design-build documents address the use of building information modeling (BIM). The agreements encourage the parties to establish protocols governing the use of BIM. The documents specify that, unless otherwise agreed, the parties will use AIA Document E203™–2013, Building Information Modeling and Digital Data Exhibit, to establish protocols for the development, use, transmission, and exchange of digital data and building information modeling.

AIA Document A145™-2015, Standard Form of Agreement Between Owner and Design-Builder for a One or Two Family Residential Project, is a new document for residential design-build projects. A145 consists of the agreement and a design-build amendment that is executed when the owner and design-builder have agreed on the contract sum.

A145 is significantly shorter than A141-2014, which is geared toward larger commercial construction projects. A145 is streamlined to include the provisions that are most relevant to residential owners and design-builders. A145 includes flexible compensation provisions, a process for development of the owner's criteria, and fill points for jurisdictional requirements unique to residential construction. A145 is structured so that the articles appear in the same order as in A141, making it easy to perform a side-by-side comparison between the two documents.

The AIA publishes several forms customized for use in design-build projects, including G744™-2014, Certificate of Substantial Completion for a Design-Build Project, and G742™-2015 and G743™-2015, Payment Application and Continuation Sheet for a Design-Build Project.

Another new document is AIA Document C102™-2015, Standard Form of Teaming Agreement Between Team Manager and Team Member for the Purpose of Responding to a Solicitation and Pursuing a Project. C102 is intended to allow multiple or cross-disciplinary parties to form a team to provide services necessary to submit a proposal, in response to a solicitation, for a shared opportunity project. C102 is not limited to use within a single project delivery method and can be used for responses to requests for proposals, design competitions, design-build competitions, or public/private partnerships.

For samples of the 2014 design-build documents, see www.aia.org/designbuild. For samples of the new 2015 documents, see www.aia.org/newdocs. For additional information, see http://www.aia.org/contractdocs/index.htm.

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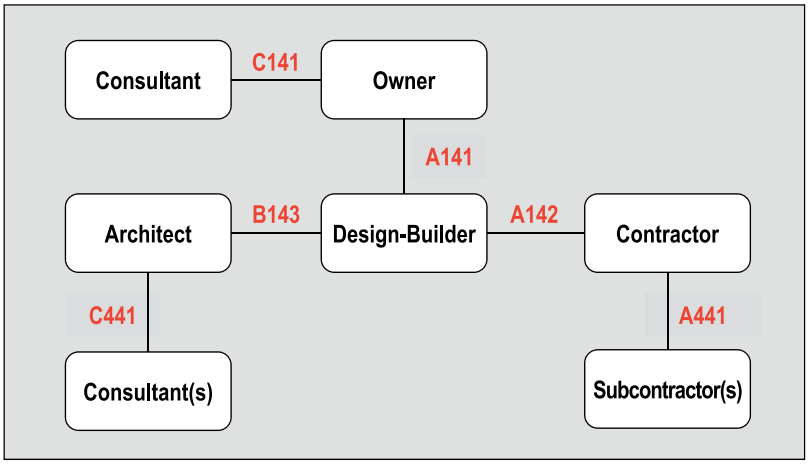
Design-Build Contract Relationships



DOCUMENTS: AIA Documents **A141**™, Owner/Design-Builder Agreement; **A145**™, Owner/Design-Builder Agreement for a One or Two Family Residential Project; **A142**™, Design-Builder/Contractor Agreement; **A441**™, Contractor/Subcontractor Agreement for a Design-Build Project; **B143**™, Design-Builder/Architect Agreement; **C141**™, Owner/Consultant Agreement for a Design-Build Project; and **C441**™, Architect/Consultant Agreement for a Design-Build Project.

Feature

CONTRACTOR PRACTICES THAT MAY RESULT IN **CONSTRUCTION CLAIMS TO RECOVER** FOR DELAYS AND INCREASED COSTS

BY RICHARD J. LONG

IN A PERFECT world, the owner never changes his mind, the engineer never alters her drawings, the contractor never malperforms, the resident engineer's decisions are perfect, and Mother Nature behaves herself. That perfect world does not exist.

In the real world, with geometric precision, the forces of owner, engineer, contractor, and Mother Nature combine to make change. The owner changes his mind. The engineer changes her drawings. The contractor fails to manage his job. Mother Nature then changes what the others have missed.

Depending on which party is assessing and determining the causes for claim generation, the perspectives cover a broad range. Voluminous claims are not foolproof indications that a compensable claim exists and often mask the contractor's responsibility for the problems that have occurred. It is frequently necessary to examine the project history in detail before intelligent judgments can be made on the validity of the claim.

The following are regarded as the primary contractor practices that often result in construction claims by the contractor to recover its increased costs and counterclaims by the owner as a result of the contractor's failure to perform. Bond producers and other surety professionals would be prudent to advise their contractors to avoid such practices and, in turn, help prevent claims.

Inadequate cost and schedule control systems

Possible explanations for why estimated costs for project activities are so inaccurate when compared to actual costs, and why planned schedules experience significant delay, include lack of integrated costs and schedule control systems; poor definition of work activities; failure to prepare an accurate, logic-linked, baseline CPM schedule; improper updating of progress schedules; and inaccurate cost allocation of contract and actual man-hours and costs to a sufficiently defined cost accounting system that can recognize cost overruns in sufficient time to enable mitigation to occur. Contractors often attempt to inappropriately blame the owner and file claims for the delays and cost overruns that have occurred.

Late and inadequate submittal of change order requests

Changes are the leading cause of delays and increased costs on construction projects. Contractors must follow the contractually required procedures for preparing and submitting change order requests. These procedures include an adequate assessment of the cost and schedule impact of the proposed change. Not only does the contractor have to make an adequate estimate of the direct costs of material, equipment, and labor costs associated with the change, but also it must address the schedule impact and associated time-related costs. This assessment will often require a time impact schedule delay analysis to determine the potential delay associated with the change. When the man-hours associated with the changes approach a level where the cumulative impact of the change may affect the contractor's labor productivity, the contractor must include the costs for increased labor man-hours that most likely will occur. If the contractor fails to perform these analyses, it may attempt to submit an end-of-project claim to recover its increased costs and avoid liquidated damages in an owner's counterclaim.

Inadequate site investigation before bidding

Contractors often venture into new geographic areas to broaden their opportunities. Too often, the contractor will bid work without performing an adequate site investigation into areas such as availability of qualified labor, labor productivity, weather patterns, underground conditions, and other projects in the area that would

compete for the available labor. As a result of not doing their homework adequately, contractors may then take every opportunity to prepare change order requests or file claims to make up for their bid errors.

Bidding below costs and over optimism

This practice would be considered a deliberate underbid, presumably justified to break into a new geographic market or new line of work. After the euphoria of winning the job disappears and the reality of losing big money on the project sinks in, contractors may be persuaded to seek every opportunity to submit requests for change orders or file claims.

Brokering the work and passing all problems to the subcontractors without adequate coordination

General contractors or large engineering, procurement, and constructor (EPC) contractors often subcontract all of the work but fail to adequately schedule and coordinate the work of the various trades. The general contractor or EPC contractor then points to the clause that it inserts in its subcontracts stating that the subcontractor must coordinate and cooperate with the other trade subcontractors. These problems often result in claims by the subcontractors that are impacted by the main contractor's failure to perform its coordination duties.

Unbalanced bidding resulting from manipulating unit prices and front-end loading progress payment weighting factors

Contractors often gamble by proposing high unit prices on types of work where they anticipate significant growth from the owner's bid quantities and lower prices on types of work where they feel that they need to be competitive. If these tactics prove to be ill advised, or if the contractor guesses incorrectly on which units will grow, the contractor may not be recovering its actual costs. In addition, contractors will try to get ahead on the cash flow curve by putting higher progress payment weighting factors (than could be justified on a balanced cost basis) on work performed early in the project to the detriment of work performed later in the project. Another approach might be submitting a higher percentage completion estimate in its pay requests for easier work, such as installing straight run pipe, and then experiencing lower productivity and higher unit costs for valve stations or small bore pipe installations, which are more difficult to install. If these attempts at cost recovery fail, the contractor may look for other opportunities to file a claim to recover its increased costs.

Failure to provide notice of delay, changes, or other impacting events

The contract often identifies situations for which the contractor is required to provide notice to the owner if delay or increased costs occur. These events include, but may not be limited to, force majeure events, changes in scope, differing site conditions, failure on the part of the owner to respond to requests for information in a timely manner, late owner approvals, and interference by other contractors. When the contractor fails to provide timely notice, the owner may reject a request for time extension, a proposed change order, or a claim for increased costs because the owner has lost the opportunity to mitigate the problem.

Failure to follow authorized means and methods and procedures

Often, the contractor is free to use its preferred means and methods and procedures for performing the construction work. However, the owner's specifications often require more expensive and time-consuming means and methods and procedures for performing the work than recognized by the contractor when preparing its bid. When the owner rejects the contractor's work method and insists on the specified means and methods and procedures, the contractor may attempt to file a claim.

Refusal to proceed with directed work pending a contract modification

Owners often disagree with the contractor's price for performing changed work but still want the work performed. To overcome this problem, contract provisions are often included to give the owner the right to make a unilateral change. If the contractor is experiencing cash-flow problems or potential delays in completing the work, it may choose to play hardball with respect to forcing the owner to formalize the change and agree to its price and time extension request before performing the changed work. When the work is eventually performed, the actual cost may be much higher than it would have been had the work been performed when the change was identified. These situations are ripe for claims.

Performing defective work

Owners may need to withhold progress payments from contractors that have performed defective work. The delay to the project completion caused by the time required to correct these defects may also justify the owner's liquidated damages claims. The cost of correcting defective work is most certainly included in the owner's counterclaims.

Hopefully, the identification of these problems will alert the contractor's management and help to avoid the need to file claims and allow for a more successful project. Surety professionals should consider reminding their contractors of these problems and strategies for claims prevention. ●

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Feature

NASBP Annual Meeting Speakers

Veterans can benefit private sector, but need help finding jobs

THE SURETY INDUSTRY shares several values with those who have served in the U.S. military, and it can provide valuable opportunities to troops making the transition to private-sector employment, according to speakers at the 2015 NASBP Annual Meeting & Expo in San Diego.

"We both underwrite security – that's the bottom line," said retired Navy Vice Admiral David Buss, who served as the Naval aviation's sixth "air boss" and was the keynote speaker at Monday's general session.

Both the surety industry and the military also stress the importance of professional education and training to ensure future success, and they "provide a level of comfort to those who we're charged to protect" and build "covenants" based on the trust and confidence of those being protected, Buss said.

The nation has a closer bond to those who have served in the military than it did during certain periods in the past, such as the Vietnam War era, and that connection extends to initiatives helping the private sector help veterans, he said.

Highlights from the NASBP Annual Meeting in Pictures. For additional pictures of the Annual Meeting, visit www.nasbp.org or go to https://www.flickr.com/photos/133411151@N07/sets/72157652788564009/

A. From left, speakers retired U.S. Navy Vice Admiral David Buss, retired U.S. Marine Corps Sergeant Major Frank Pulley, Tom Padilla and Mark McCallum. **B.** Program Committee Co-Chairs Matt Cashion, center, and Don Appleby, right, spoke with Hiring Our Heroes Advisor Frank Pulley, left. **C.** Doug Bauldwin, second from left, spoke about the success of PTS treatment. He is pictured with from left Jeffrey Hecker, William Martin, and retired Navy Rear Admiral Denny Wisely, a representative of the Blue Angels Foundation. **D.** Larry McMahon, far left, and Tom Padilla, far right, presented Tiger Trust awards to, second from left, Stan Halliday, Jacob Fulmer, and Mary Alice McNamara of Travelers Bond and John Bustard of King & Neel.

E. From left, Mike Ito, Stephanie Ito, Tom Padilla Jr., Todd Loehnert, Tom Padilla, and Kimberly Padilla enjoyed the reception. **F.** NASBP helped raise money for the Blue Angels Foundation PTS Program, from left Denny Wisely, Jeffrey Hecker, Kathy Murphy, Carl Dohn and Tom Padilla. **G.** Retired U.S. Navy Admiral David Buss was the Keynote Speaker. **H.** Todd Loehnert, left, received the President's Award from Tom Padilla, right. **I.** Susan-Hecker, far right, presented a plaque to Tom and Kimberly Padilla for Tom's service as NASBP President this past year. J. Gary Dunbar, left, accepted the Bruce T. Wallace Award from Tom Padilla, right.

"It really is a symbiotic relationship that I think is really important for our future," he said in an interview.

One of those initiatives is Hiring Our Heroes, which was established by the U.S. Chamber of Commerce Foundation in 2011. Frank Pulley is a retired Marine Corps sergeant major who serves as a consultant and adviser for the program. He said that his company, Military Veteran Solutions, has been able to assist even more people since affiliating with the initiative.

In fact, Hiring Our Heroes has held more than 900 events in the U.S. and overseas and has confirmed that 25,000 veterans and their spouses have been hired as a result of such events, Pulley said.

One resource is the foundation's Employer Roadmap, a digital tool that identifies veterans and whether they might meet the experience requirements for a particular job, he said. Such efforts aim to bridge the gap that exists between veterans and civilian companies as less than 1% of people in the U.S. have served in the military.

"There's a rhythm, a cycle, a structure" in the military, "and then you get out and you're dealing with civilian employers. Even though we're speaking English, there's a language barrier," he said.

Pulley and Buss both suggested that businesses can assign mentors to veterans they hire, ideally if the mentor is also a veteran, in order to maintain the teamwork and personal bonds that veterans know from their military service. Buss hopes that, after NASBP's Annual Meeting, members who attended will return home and make efforts to help veterans find jobs, even if they are not hiring directly.

"This is a very broad group, very representative of every part of the country," he said of NASBP.

Pulley said the ultimate goal is to reduce unemployment, underemployment and homelessness among veterans to avoid not just an economic problem, but also a national security concern. The military is an all-volunteer force, and the reason it has been successful is that the country has helped care for soldiers after their service concludes, he said.

"What we're really talking about here is giving our veterans a hand up and not a handout," he said.

For more information about Hiring Our Heroes, visit http://www.uschamberfoundation.org/hiring-our-heroes.

Continued from page 19

that the public owner was obligated to not only ensure that a bond was posted at the inception of the project, but also to require the prime contractor to post a substitute bond after its surety became insolvent.

Similarly, in *Sloan Construction Co. v. Southco Grassing, Inc.*, 395 S.C. 164 (2011), South Carolina's Supreme Court declined to hold a public owner liable for failing to ensure that a viable payment bond remained in place for the life of the project, after the surety became insolvent and entered into liquidation. The Michigan Appellate Court came to a similar conclusion, noting that, "it would be a herculean task for those governmental units which are engaged in a number of public works projects at any given time to continually check to ensure that a payment bond is still in force for each project and to determine the identity of the various subcontractors and suppliers and to advise them of the status of the payment bond." *Barnes & Sweeney Enters v. City of Hazel Park*, 425 N.W.2d 572, 575 (Mich. 1988).

Conclusion

Thus, although an unpaid subcontractor may, under certain circumstances, enforce its payment claims directly against a public owner for failing to ensure compliance with the bonding requirements, it is extremely unlikely that a court would find a public owner liable for failing to ensure that a viable bond remained in place through the life of the project. This, of course, poses a particular challenge to subcontractors and suppliers, who have little ability to monitor the viability of the bond during the course of the project.

Even with a potential right of recovery directly against the public owner, a subcontractor's best course is still to obtain a copy of the payment bond prior to executing the subcontract. Depending on the jurisdiction, the subcontractor may even have an established right to receive a copy of the payment bond, either from the contracting officer or the prime contractor. If the contractor fails to make timely payments during the course of the project, the subcontractor will be in position to notify the surety on the payment bond about unpaid amounts due. Failing to be proactive about the payment bond can leave the subcontractor holding the bag.

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