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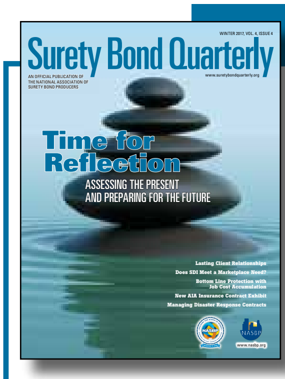

ON THE COVER

WINTER 2017

As the year comes to an end, it is the perfect time to analyze and learn from our past successes and challenges, to honestly assess where we are currently, and to proactively plan for the challenges and opportunities ahead. This winter issue of *Surety Bond Quarterly* offers surety professionals tools for such assessments so that the industry will be poised for successful growth in the New Year.

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"YESTERDAY IS NOT OURS TO RECOVER, BUT TOMORROW IS OURS TO WIN OR LOSE."

– President Lydon B. Johnson

Winter marks the culmination of one calendar year and the start of another year. Not so far back in our history, people prepared for many months for the approach of the winter season, storing food, mending the home, cutting and stacking wood for fuel for the hearth, among other sorts of preparation for the long, dark season and the transition to springtime. The quiet of winter also gave individuals, at least the ones well prepared for its onset, time to slow down and time for reflection and assessment. A person could look back at the activities and events, both large and small, that had shaped his or her year and could surmise what plans and actions would be important for thriving in the coming year. Past mistakes might be analyzed, trends identified, advice sought, and predictions digested, all toward laying the groundwork for a fresh start in the New Year. Preparation, insight, and anticipation were and continue to be key ingredients to position for future success.

This winter issue of the *Surety Bond Quarterly* serves as a reflection on some of the "past mistakes," "trends," "advice," and "predictions" that have impacted the construction and surety industries over the past year and, in some instances, over many years. Each article is included with the goal of helping readers to understand, to assess, and to put into perspective the challenges and opportunities that may lie ahead.

Rebecca Glos and Amanda Marutzky, attorneys with the law firm of Watt, Tieder, Hoffar & Fitzgerald, LLP, provide a rundown of considerations for surety claims professionals regarding subcontractor default insurance, detailing distinctions between such insurance and surety bonds. R.A. Bobbi Hayes, a certified public accountant with Carr, Riggs & Ingram, LLC, details the importance of contractors understanding how to properly allocate job indirect costs to ensure profit realization. With respect to AIA's recent issuance of revised standard construction contract forms, the new insurance and bonding contract exhibit is analyzed by attorney Todd Regan of the law firm of Robinson+Cole, LLP. Barron Avery and William O'Reilly, attorneys with the law firm of Baker & Hostetler, LLP, give advice on considerations for managing disaster recovery contracting. Other articles focus on building long-term relationships and cyber plan considerations. Also included for winter is a web exclusive article posted on suretybondquarterly.org, authored by attorneys Mike Zisa and Susan Elliott with the law firm of Peckar & Abramson, covering potential liability exposure to surety professionals from False Claim Act violations.

President Lyndon B. Johnson once remarked: "Yesterday is not ours to recover, but tomorrow is ours to win or lose." I hope the information presented in this winter issue of *Surety Bond Quarterly* help you to take stock of our present challenges and future opportunities, so that we, as individual businesses and collectively as an industry, never lose sight of the right path for suretyship.

Warmest regards,

Mark H. McCallum
NASBP CEO

Relationships for the Long Run

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LIKE RUNNERS PREPARING for a marathon, surety bond producers need to think long-term when building lasting connections with their contractor, subcontractor, and specialty trade clients.

"The most important element in building a good relationship is building a level of trust," said Eric Zimmerman, Vice President, Propel Insurance, Seattle, WA. "That just happens over time, with consistent feedback and follow-up and doing what you're say you're going to do with people."

The process begins with finding the right customers.

"I typically try to find out about the character and the characteristics of a client and what their reputation is in the marketplace, through my association relationships and my existing clients. Then I find the ones that have similar interests," said Brad Babcock, Owner of Babcock Solutions, Cedarburg, WI. He enjoys outdoor activities like hunting, fishing, and cycling and finds that spending time with people in those settings gives him time to talk with them informally.

"I like to get a feeling for how they handle their personal life and what their thoughts are, because that will give me a good indication as to how they run their company," he added.

Not every customer will be a good fit. "Over the years I have had companies that brought in good financial statements and say all the right things, but I don't take them on as a client because something doesn't feel right," said Brian Edmunds, Vice President, Rosenberg & Parker of Canada Inc., Toronto, Ontario. "I am usually proved right."

"As you're talking, you may realize that their value system is not the same as yours, that their goals and yours are not that much in line," added Bryce Guignard, President, Guignard Company, Longwood, FL.

Walking away from a potential client may be more difficult if you're just starting out in the business. But to form successful long-term connections, both you and the client will need to feel comfortable and confident about dealing with each other.

Establish the Groundwork

Runners follow a plan for getting in shape so that they can work up to longer distances. Forming long-term relationships with surety bond customers begins with a well-planned,

TEN TIPS FOR BUILDING STRONG RELATIONSHIPS

1. **Choose the right client.** Look for common interests, common values, and a common business philosophy.
2. **Establish expectations early.** Let them know what they can expect from you and what you will need from them to get the job done.
3. **Keep it personal.** Emails, texts, and other electronic contacts can't replace the connections built through regular in-person visits, phone calls, etc.
4. **Add value.** Advocate for your customer and serve as a resource who can offer solutions not only on bonding but also on other areas that can impact their business (like recommendations for a new lawyer or accountant, for example).
5. **Understand your client's business.** Get to know their company, their projects, and their people.
6. **Learn about their industry.** Join their professional associations. Keep abreast with news about their competitors and partners, including other general contractors, subcontractors, and specialty trade contractors. Stay informed about any laws and regulations that could impact them.
7. **Don't take a relationship for granted.** Treat every client as if he or she were a new client. Don't assume that because they've been with you a long time they will always be with you.
8. **Don't get stuck in a rut.** Change things up every year, adding some new service that will benefit your clients.
9. **Develop a relationship of trust.** Your client needs to know that you are a person of integrity; you need to feel that you can rely on them to do what they say they will do.
10. **Have confidence in yourself.** Your client needs to feel comfortable that what you're proposing is in their best interest, so you need to believe that yourself.

getting-acquainted process that allows both companies to learn more about each other and to lay the foundations of trust.

Michael Petrasek, Sr., recently retired from Seubert & Associates, Pittsburgh, PA, after 44 years in surety, said that it's important that surety companies demonstrate an ability to perform during this period, since they ask for a lot of sensitive information from their clients up front.

"You have to be able to lay out some expectations on what you think you're going to accomplish and be able to deliver. You start with fulfilling that first commitment and you keep building on that," Zimmerman said. "I think a good relationship also comes with a certain amount of future forecasting for them, anticipating what's going to happen next, anticipating what the upcoming questions might be and giving them counsel on some ways to prepare for that and/or change the direction to achieve what they're looking to achieve from a bonding standpoint."

Lawrence McMahon, Executive Vice President/Surety Manager at the Construction Services Group of Alliant Insurance Services, San Diego, CA, starts with "360 Days of Stewardship" when he acquires a new customer. He first meets with them and introduces his staff; a few weeks later they have a social meeting (a lunch or dinner) to discuss expectations. After that, he meets with the clients on a quarterly basis to ensure that the agency is delivering what they expected.

"One of my contacts with them could be just delivering a bid bond or a final bond, physically handing it to the owner and explaining what we do," McMahon said. "You're building rapport and actually bonding with them during that process."

With this structure in place, the agency is able to work through any initial difficulties, McMahon added. When the first few bonds for one new client didn't go as smoothly as they wanted, he met with them and reset expectations so that it would never happen again.

Keep it Real

Marathon runners know that training on a treadmill, while sometimes helpful, is no substitute for getting out and actually pounding the pavement. In the surety world, technology-enabled contacts can't substitute for face-to-face interactions when it comes to cementing long-lasting connections.

"Make your relationships personal; don't allow them to become email, voice, texting relationships. There's no replacement for the personal; that means being in front of your client and a lot of phone calls," said Edmunds. "When trying to address complex issues, the email trap is worse than phone tag. You end up exchanging 10 emails back and forth. It's crazy. I'm in the relationships business and you can't build and maintain relationships with emails."

"A lot of the answers that come from here aren't black and white and require a little bit of hand-holding and explanation. You can't give value-added services by email or by text," Edmunds added. In a half-hour meeting or five to 10-minute phone call, however, he can generally cover the issue with the client.

To build strong ties between his agency and the contractor, Edmunds gets to know not just the person he deals with on a regular basis, but also the support staff such as the receptionists, assistants, and estimators. "I call them secondary relationships, and I think they are as important as the primary relationships. Secondary relationships with our service staff are also extremely important to the overall relationship and are encouraged. Take your key staff with you whenever you can and work at maintaining free-flowing communication within your office."

Babcock leaves Fridays open so that he can stop in and visit three to five clients each day. "I probably get in touch with every one of my clients at least six to nine times a year. Sometimes I end up talking six hours with one that has issues going on, and sometimes it's just two or three minutes because they are busy. I like these impromptu meetings, because they're not preparing for it and you get whatever's on their mind right then and there," he said.

Maintain the Pace

Runners who want to sustain or improve their position over the course of a long race must pay attention to the way they're traveling at every point. To forge strong links with their customers, surety professionals must monitor and nurture relationships on an ongoing basis.

"It's like any relationship; if you neglect it or don't communicate, it's not going to work. I'd equate it a little to a marriage, where you really have to communicate constantly or little things that build up cause problems," said McMahon.

"The key to nurturing relationships is to be there consistently for that person; you are there to share experiences," added Guignard. "They see how you respond, you see how they respond, and you develop a stronger bond."

One way to add value to a relationship is learning everything you can about your client's competitors and building partners.

"I really focus on my clients' competition, not only because his competition may be a prospect but more importantly because what his competition is doing makes an impact on what he does and how he does it," said Edmunds. "If you know who his competition is, you're able to gauge the market conditions he is dealing with as he tries to manage an effective business."

Know When to Call a Halt

Runners may become injured during the course of any race. Sometimes they may be able to power through, but other times the best thing to do is leave the course.

Connections between surety bond producers and their customers can become strained when things aren't running as smoothly as either side would wish. The best way to handle a problem is to be upfront about it and to try to fix whatever has gone wrong.

This can be an opportunity to get closer to a client. "We need to be a positive reinforcement and try to help our clients work through situations even when we have to deliver bad news or ask them to do something like increase capital in their company to restore their financial condition," said Zimmerman.

He recently was working with a client who was doing a very difficult joint venture project with a foreign-owned corporation. As they worked through some challenging situations, both he and his client occasionally vented their frustrations.

"But both of us came back with very quick acknowledgments that we were venting because of the situation, and we both appreciated what the other was doing to work through it. We ultimately got it done and maintained a strong relationship. I think that's inherent in a healthy relationship, to be able to be real with a client and not fear that's going to jeopardize your relationship," Zimmerman added.

But sometimes the relationship can be too seriously strained to retrieve. That can happen if there's broken trust or if the client's business or values or people have changed. At that point, you might have to tell the client that you are no longer a good fit and that they might do better finding someone more in line with their current business philosophy.

Bringing Your Best

Runners earn the respect of their peers by consistently putting forth their best efforts. Surety bond professionals earn the respect of their contractor and subcontractor clients—and build lasting connections with them—by conducting business in an ethical manner.

"Clients have to respect me as a professional and what I do. I'm not a commodity, and if they want to treat me as a commodity, we just don't do business," added Babcock.

"Clients and contractors sometimes think of their banker and their lawyer and their CPA in one light and treat the surety producers as some kind of huckster," added Petrasek. "If you allow yourself to be treated like that, you won't have a professional relationship with your client."

"I think the most important thing is to develop trust," said Guignard. "You have to demonstrate that you are good at what you do, that you are professional and honest and have integrity."

In the long run, relationships built upon mutual trust and respect will be the most enduring and the most satisfying for both surety bond professionals and the contractors and subcontractors that they serve. ●

feature

Subcontractor Default Insurance: Relevant Considerations for the Surety Claims Professional

RUSLAN GRUMBLE/SHUTTERSTOCK.COM

 

BY REBECCA S. GLOS AND AMANDA L. MARUTZKY

SUBCONTRACTOR DEFAULT INSURANCE (SDI), or Subguard,™[1] was created in 1995 as an alternative to surety bonds. It is often obtained in connection with a larger construction project and as a part of an owner-controlled insurance program (OCIP). SDI has primarily received attention among larger contractors as a way to manage risk of subcontractor failure on private construction projects. Indeed, SDI was originally marketed to meet the needs of large general contractors, construction managers, and design-build firms with expenditures of $50 million plus.[2] However, as SDI policies are being advertised by more and more insurers, the industry may see a shift in the number of contractors opting for SDI as a replacement for traditional subcontractor bonds. Whether managing a project with a subcontractor in default where SDI is involved or educating others in the industry regarding the pros and cons of each, the surety claims professional needs to be aware of the significant differences between SDI and bonds. A number of benefits provided by performance and payment bonds are absent under SDI, benefits which may have a significant impact on loss mitigation and which need to be communicated to contractor consumers.

Number of Players, Risk, and Regulation

The primary distinction between SDI and surety bonds is the type of contractual agreement involved. SDI consists of a two-party agreement between the insured contractor and the insurance carrier. Upon a subcontractor's performance default, the carrier indemnifies the contractor for costs incurred. The general contractor retains a portion of the risk through high deductibles and co-payments. SDI may be written on a non-admitted or surplus lines basis; therefore, if the SDI carrier becomes insolvent, there is no recovery under the state guarantee fund.

Surety bonds, on the other hand, encompass a tripartite agreement between the subcontractor principal, surety, and contractor/obligee. In this arrangement, the surety guarantees that the subcontractor will perform the construction subcontract in favor of the contractor. It is a complete risk transfer from the general contractor to surety, with first-dollar coverage. Sureties are admitted and regulated by state insurance departments, regularly filing rates and financial information.

Legal Precedent

Surety bonds have been in existence for millennia. While there are well-established statutes and case law governing surety bonds, which provide generally clear guidelines for surety claims professionals, there are few reported decisions on major SDI disputes. In 2011, the Ohio Supreme Court addressed the issue of whether a public works bond statute applied to a construction manager at risk on a public works project.[3] The owner had not required that the construction manager obtain performance and payment bonds as normally would be required under the Ohio public works bonding statute. The construction manager did, however, provide a $20 million irrevocable standby letter of credit and also purchased subcontractor default insurance. Holding that the statute and its bond requirement only applied to competitive bids, and did not apply to a construction manager at risk, the court held that no bonds were required for that public project.[4]

Some in the industry have opined that this case raises the question as to whether SDI is a viable alternative to traditional surety bonds.[5] Regardless, even though SDI has now been in existence for over twenty years, it is still uncertain how various jurisdictions will rule on SDI issues in construction-related disputes. While some take the position that the argument of "older therefore better" is "misplaced,"[6] the fact remains that SDI is still an unknown quantity in the realm of construction jurisprudence. Surety claims professionals in the business of risk assessment may undoubtedly find it easier to evaluate a default when there are legal guidelines with which to compare it.[7]

Cost Comparison

Cost is one of several factors to be considered in deciding whether to purchase a performance bond or SDI to cover the risk of a subcontractor default. SDI involves deductibles and co-payments while bonds do not. Aside from the premium, no additional payments are required by the principal to trigger bond coverage. Protection is guaranteed upfront. SDI co-payments are capped at the agreed upon retention aggregate, which is the maximum amount the insured will have to pay for a claim arising during the policy period.[8] It is not uncommon for SDI deductibles to be as high as $500,000 to $1 million.[9] Notwithstanding, cost is often a major benefit cited for SDI over performance bonds. SDI can be purchased for as little as 50 percent of the cost of bond premiums, which range from 1 to 1.25 percent of the value of the subcontract. Whereas performance bonds are issued in the equivalent value to the subcontracts, by comparison, the policy limit on an SDI policy is often less than the total value of all of the subcontracts–usually ranging from .4 to .85 percent of the total subcontract values.[10]

What's Covered?

SDI policies are structured to cover five broad categories of losses: (1) the cost of completion of a defaulted subcontractor's scope of work; (2) the cost of correcting defective or nonconforming work/materials;[11] (3) certain legal and professional fees incurred in connection with a subcontractor's default; (4) costs in the investigation or adjustment of the default; and (5) liquidated damages, job acceleration, and extended overhead costs incurred by the insured as a result of the default.[12] For megaprojects, it usually covers the performance of all subcontractors on both first- and second-tier subcontracts. Unlike some bonds, SDI covers indirect losses from a default, such as liquidated damages, acceleration of other subcontracts, and extended overhead.[13] Notwithstanding, many subcontract bond forms and subbonds based on the AIA A312 allow for recovery of these damages, including liquidated damages.

Proponents of SDI contend that surety bonds have less specificity as to the type of losses covered, which often results in litigation (that is, disputes over delay damages and attorney's fees).[14] Nevertheless, unless there are endorsements for additional insureds, under an SDI policy, no coverage is provided to an owner,[15] other subcontractors, suppliers, and/or laborers. An owner can be added to an SDI policy through a Financial Interest Endorsement,[16] with dedicated limits specific to the owner. This endorsement ensures the owner still has coverage in the event the general contractor is not bonded and becomes insolvent. Without this endorsement, the owner can only seek recourse through the general contractor under the contract or through the general contractor's surety. With it, however, if the general contractor becomes insolvent, the policy reverts to the owner to enable it to make a claim. It is still generally untested, however, whether these endorsements function to allow the owner to recover the full amount of the loss just as the general contractor would or whether the insurer would treat the claim differently.

While SDI protects against subcontractor default, there is no protection offered to subcontractors and/or suppliers against the failure of an owner, general contractor, or construction manager to make timely payments. Those in favor of bonds would argue there really is no one-to-one comparison. SDI is simply not a replacement for payment bonds.

SDI proponents counter that the insured still has the ability to claim losses, which would satisfy downstream payments to tiered subcontractors and that those subcontractors still have their lien rights.[17] Hypothetically, an insurer and general contractor could agree to cover pass-through claims of major trade subcontractors. The general contractor would still bear the responsibility for the deductible and co-pay, and the subcontractor would qualify the lower-tier subcontractors. The cost of the premium would likely be split between the general contractor and primary subcontractors. But it is unclear how many insurers would allow these types of claims under their policies. The general contractor is also unlikely to submit subcontractor or supplier bills to the carrier unless: (1) the general contractor still needs that entity to complete its work and therefore get paid; or (2) that entity has filed a lien and is forcing the pass-through claim in exchange for a release. Finally, if the general contractor becomes insolvent, it will not be able to cover the deductible; and the lower-tier subcontractors and suppliers have no remedy.[18]

The bottom line is, in its current form, SDI has no payment bond equivalent. SDI does not meet state and federal (Miller Act) statutory requirements for public projects, which require payment protection, in the form of a payment bond issued by a surety, to subcontractors and/or suppliers.[19] Although the court in *Pavarini* allowed the substitution of SDI for a statutorily required surety bond,[20] that case was limited in its application to that state's public bidding statutes; and no other cases are known to have addressed this topic. In certain jurisdictions, SDI's lack of coverage for lower-tier subcontractors and suppliers may not even satisfy performance surety requirements.[21] Therefore, while we may be seeing a trend of increased use of SDI policies among larger general contractors on private construction projects, that may be the only context in which they are used.[22]

The Prequalification Process

The surety's issuance of a performance bond equates to an assurance of the subcontractor's performance of its scope of work on the project. Prior to providing this guarantee, the surety must prequalify the principal subcontractor through the underwriting process. This process involves analyzing financial viability, credit history, project experience, reputation, progress on other subcontracts, management capability, equipment, size, geographic location of work, and the subcontractor's overall capacity to perform the job.[23] If a subcontractor is deemed too small or lacking in sufficient performance history, typically it will not qualify to be bonded.

By comparison, under an SDI policy, the general contractor has the responsibility to prequalify its subcontractors. The general contractor, rather than the surety, will gather financial data and conduct its own testing to determine if the subcontractors have the resources to perform the job they are being hired to complete. The insurance carrier plays no role in this process. The issue of confidentiality is at play. While the subcontractor has a confidential and on-going relationship with the surety, many subcontractors are uncomfortable providing private financial data to a general contractor that may be its competition on a later project.

Placing this onus on the general contractor also requires a substantial investment of resources to ensure proper prequalification of subcontractors. This responsibility arguably incentivizes the general contractor not to use "new" subcontractors or vendors, which goes against the public policy behind supporting Small Disadvantaged Businesses or other MBEs.[24] Because the general contractor has the freedom to choose the subcontractors it feels are right for the job, subcontractors with the most experience and whose trades have the lowest risk of default are those who prequalify.[25] In addition, subcontractors that normally would not qualify for a performance bond may still be covered under SDI.[26] While this may seem like good news for contractors, this is a potential pitfall for the surety claims professional. As an example, a general contractor may accept into its SDI program a subcontractor with a lower net worth because its price is so low. The general contractor takes on the risk of hiring that subcontractor because it has its SDI carrier to fall back on. Thereafter, a claim is made on the general contractor's performance bond; and the surety has to step in. It turns out the SDI-covered subcontractor performed non-conforming work that costs millions. Even though the surety may have enough in contract funds to cover the repairs, liquidated damages are still being assessed as time passes.

The general consensus among surety bond producers is that a general contractor's prequalification vetting process is more relaxed and, therefore, a "big gamble."[27] In every case when a subcontractor defaults, there is delay and disruption. These defaults are less likely to occur if subcontractors are more thoroughly prequalified by bonding companies that have established methods and procedures. In addition, oftentimes the subcontractor's owner(s) personally indemnify any loss sustained by the surety under the bond, which consequently incentivizes the owner(s) to complete the bonded work prior to the unbonded work. From a risk perspective, this control over prequalification and indemnity is a valuable loss-prevention measure for a surety claims professional.

Others in favor of SDI have cautioned against making the incorrect assumption that a surety (rather than a general contractor) will always do a better job of assessing the subcontractor's likelihood to default. Their counter-argument is that the general contractor has placed its own funds at risk under an SDI program through the large deductible and co-payments. This motivates the general contractor even more so to ensure the subcontractor is up to the task of timely and correctly performing its scope of work. In addition, a general contractor may be the best party to understand the operational capabilities of the subcontractor.[28] One construction manager that has had success with SDI "understand[s] and recognize[s] that [it] cannot see the same depth of information to which a surety has access through due diligence and underwriting within their bond program" but ameliorates that fact by being more conservative in its underwriting and prequalification.[29]

Contractor v. Surety Responsibilities

A performance bond mandates that the surety has the primary obligation to step in and remedy a subcontractor default. The surety then has various options under the bond such as takeover, financing the subcontractor's completion of the work, or paying the contractor/obligee. With SDI, the insured general contractor assumes responsibility for taking over the project and managing the defaulting subcontractor's obligations. While this added responsibility may not be too burdensome for a larger contractor that has the resources to fill the gap, it is an impractical expectation for medium-sized to smaller contractors to easily replace the defaulting subcontractor.

Following a default where a surety bond is in place, the surety pays the loss to the contractor/obligee and in turn seeks indemnity from the subcontractor/principal. With SDI, the insured general contractor pays to replace the defaulting subcontractor and then seeks reimbursement from the carrier. The general contractor makes a claim on the policy, and the carrier agrees to start paying within 30 days receipt of documentation to back up the claim. This means within 30 days of receipt of evidence, the general contractor has already paid out its deductible.[30] If the subcontractor is ultimately found not to be in default, the proceeds paid to the insured must be returned.[31] This process of "pay first, claim later" can cause a significant strain on a medium-sized or smaller general contractor since it impacts that contractor's cash flow and ability to pay its other subcontractors. If the general contractor cannot or chooses not to pay its subcontractors, those subcontractors are left without recourse to file a claim. In essence, only a larger contractor with the ability to build a reserve to pay for deductibles and any co-payments will be successful with SDI. Even then, the insured contractor is contractually obligated to recover funds paid out under the policy. The burden and expense for contesting determinations with carriers fall on the contractor, leaving it to devote significant time and resources not reasonably related to construction of the project.[32] Even if the contractor has built up a reserve, sometimes that may not be enough.[33]

Competing/ Overlapping Coverage

What happens when the responsibilities of the general contractor and the surety overlap? A new scenario has arisen where an SDI policy is in place, the general contractor defaults the covered subcontractor and submits a claim, and the proceeds are issued under the policy to complete the defaulting subcontractor's scope of work. Thereafter, the general contractor also defaults, triggering performance bond coverage. This scenario opens up a flood of new issues through which the surety claims professional must navigate with little to no jurisprudence for guidance.

A primary question is whether, in this event, by stepping into the shoes of the principal (the defaulted general contractor), the surety has the same rights and defenses (and, significantly, obligations) as the contractor under the terms of the SDI policy. To help answer this question, the surety claims professional should first look to the terms of the SDI policy to see if there is an anti-assignment clause. While most indemnity agreements provide that the surety has the right to make any assignments necessary to enforce its rights as the indemnitor(s)' attorney-in-fact, in turn, most SDI policies contain an anti-assignment clause prohibiting the insured general contractor from assigning the policy absent the insurer's written consent and endorsement. Even if the anti-assignment clause is in place, however, depending on the governing law applied to the interpretation of that clause,[34] it may or may not be held valid as to "post-loss proceeds" of the policy, or proceeds resulting from the subcontractor's existing defaults. For example, under both New York and Florida law, while assignment of the policy itself prior to a loss is invalid without the insurer's consent, no such consent is necessary for an assignment of the right to policy proceeds after the loss.[35]

Whether an assignment is determined "pre-loss" or "post-loss" is based on whether the assignment increases the risk to the insurer. On this point, a completing surety and insurer will likely disagree. The surety claims professional should argue that the insurer is still covering the risk it evaluated when the policy was written--that is, the same scope of work. On the other hand, the insurer may counter that the risk has changed since the entity responsible for the obligations under the SDI policy has changed (from insured general contractor to completing surety). The surety can sidestep this argument when the assignment is for the insured's rights in the SDI proceeds only and not in the policy itself. By not assigning the actual policy (which again would likely be forbidden anyway through an anti-assignment clause) but rather assigning only the post-loss proceeds of the policy, the surety receives the policy benefits while the responsibilities (including any repayment provisions) remain with the general contractor.[36]

The surety claims professional must also be wary in this scenario of how SDI coverage impacts the surety's performance options.[37] When the bonded contract requires SDI and the surety opts to take over completion of the bonded project, this action could void SDI coverage as the entity responsible for the obligation has changed. Because the terms of the bonded contract requiring SDI must be met, unless waived by the owner, the surety's completing contractor will have to provide SDI coverage.[38] A lapse in SDI coverage during the period between default and takeover could also result in a lack of coverage for defective work performed by the original subcontractors.[39] Therefore, this type of coverage may not be possible if the surety chooses to do a takeover and re-let. To remedy this, an owner may demand that the surety expand its coverage under the performance bond to cover defective work.

Further, in light of these potential coverage issues, the completion contractor may not even be able to ratify the original subcontractors. In lieu of incorporating lower priced ratified subcontracts into the completion contractor's bid, the surety may be forced to accept higher bids from subcontractors new to the project. This likely result leaves the surety with an unwanted higher cost to complete.

Notably, the above-mentioned difficulties in a takeover, where SDI coverage is contractually required, arguably tips the surety's risk scale in favor of financing, rather than re-let. Financing allows a surety to avoid the insurer's "changed entity" argument and, working with the principal general contractor, secures unbroken SDI coverage for past, present, and future subcontractor failures. One potential solution is for a surety pre-claim to request that the principal obtain a financial interest endorsement to the SDI policy in favor of the surety. If such an endorsement is not obtained, the surety claims professional should investigate whether there is such an endorsement in place in favor of the owner, which would allow the surety claims professional to work with the owner to preserve SDI coverage. In the absence of either endorsement, post-claim a surety must account for the potential absence of SDI coverage in assessing the surety's risk in selecting a completion option.

In sum, although currently rare, this scenario could become more and more common with the increased use of SDI on larger private projects. A surety claims professional faced with these facts should thoroughly investigate

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the policy language and governing law and use express, specific terms in any assignment, cautiously assigning SDI policy benefits only, not obligations.

Subrogation Rights

Surety bonds are issued upon receipt of consideration in the form of an indemnity agreement that provide that the surety is a secured creditor for all losses the surety sustains by reason of having issued the bonds. The agreement grants the surety subrogation rights in various interests such as proceeds from the bonded contracts. An SDI policy dictates that the insurer has a right to subrogation against a defaulting subcontractor. The insured general contractor is prohibited under the policy from taking any action that would interfere with the carrier's rights of recovery against any party responsible for the loss. These subrogation rights, though similar, are not competing in that the insurer maintains its ability to recover its losses from a defaulting subcontractor while a surety has its rights against the principal insured by virtue of an indemnity agreement.

Length of Investigation Period

After a claim has been made on the performance bond following a subcontractor's default, there is always a period of investigation during which the surety determines whether or not the claim has merit.[40] That investigation period is necessary to ensure a default has actually occurred, but it has the potential to cause project delays and cost overruns.[41] Under an SDI policy, the general contractor decides the best way to remedy the default situation without any input from the carrier.[42] General contractors and construction managers in the industry may favor this ability to proceed without having to wait for a determination from the third-party surety. In short, the investigation period may be faster because the general contractor is free to proceed with the work while simultaneously submitting the claim to its carrier. One contractor advises surety claims professionals who wish to compete with SDI need to work against the "perception that sureties are slow to respond to a claim under the remedies afforded by the bond."[43]

Coverage/Protection Period

A surety bond continues to provide protection against legitimate performance and/or payment bond claims until: (1) the time for filing suit has expired (as stipulated in the bonded agreement); or (2) the relevant statute of limitations expires. SDI policies are generally written as "claims-made" policies, meaning any claims must be made during the policy period (usually one calendar year). The policy period depends on the policy language at issue, and while some policies permit claims for a period of up to 10 years after project completion, such is not the norm. One effect of a claims-made policy is that, if defective workmanship not discovered until after the policy expires or is cancelled, those claims may not be covered. In that way, although SDI is advertised as providing coverage for the cost of correcting defective work, there are clear limitations.

Coverage Cancellation/ Voided Coverage

Once a surety bond is executed, it remains in force and may not be cancelled (even for non-payment of premium) without consent of the obligee. Conversely, coverage under SDI may be voided or cancelled if certain underwriting procedures are not followed or incorrect information provided. Thus, even with an SDI policy, reimbursement by the insurance carrier is not necessarily guaranteed. All of the policy's terms and conditions must be complied with, the insured has to maneuver around exclusions, and the policy is limited by its overall loss limits and the fact that it is often project-specific.

Conclusion

The reputation of increased cost for bonds and lengthy investigation process involved in bond claims upon a subcontractor's default has allowed the introduction of SDI into the marketplace in lieu of traditional surety bonds. While this alternative may be viable and even successful for the small minority of larger general contractors on a private project with the resources and reserves to hedge against the significant risk of subcontractor default, SDI is not likely to be a replacement for traditional surety bonds any time soon.

An earlier version of this article was presented at the Western States Surety Conference (April 21, 2017) in Seattle, WA.

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ENDNOTES

1 Subguard™ is the most prevalent type of SDI, created by Zurich Financial Services. Throughout this paper the terms will be used interchangeably.

2 Terry Gray, *Point/Counterpoint; Default Insurance–An Alternative to Traditional Surety Bonds,* 22 WTR CONSTRUCTION LAW 17 (2002); Andrew Zimmerman, Carl Bloomfield & Shane Riccio, *Contractor Default Insurance: A Nuanced Alternative to Performance Bonds* (May 10, 2013), http://www.grahamco.com/KnowledgeCenter/whitepapers/nuanced-alternative-to-performance-bonds/.

3 State *ex rel.* Am. Subcontractors Ass'n, Inc. v. Ohio State Univ., 950 N.E.2d 535 (Ohio 2011); CONSTRUCTION BRIEFINGS No. 2012-3.

4 *Id.*

5 Anna H. Oshiro & Michael S. Zicherman, *Hard Hat Case Notes,* CONSTRUCTION LAW (Fall 2011) at 43.

6 Michael S. McNamara, *Subcontractor Default Insurance – A Modest Rebuttal,* GRAVEL2GAVEL CONSTRUCTION LAW BLOG (Mar. 1, 2016), http://www.gravel2gavel.com/2016/03/subcontractor-default-insurance-modest-rebuttal.html.

7 One area of law of which a surety claims professional should always be aware is whether there is a potential of punitive damages in an active or pending construction dispute. Because SDI is viewed as traditional two-party insurance, there is an implied covenant of good faith and fair dealing that subjects an insurer to potential bad faith claims and punitive damages. By contrast, several jurisdictions, including California, have developed case law under which sureties cannot be held liable for bad faith refusal to pay and delay in processing claims under the reasoning that the surety's obligations to its principal are distinguishable from an insurer's obligations in the traditional insurance context. *See* Cates Constr., Inc. v. Talbot Partners, 21 Cal. 4th 28, 41 (1999). This insulation from bad faith claims and accompanying punitive damages should not be underrated. Litigating these claims is often time consuming and expensive for all involved.

8 Susan L. McGreevy, *Working on a Subguard Project: Loss of Protection for Subcontractors©* (2006), https://higherlogicdownload.s3.amazonaws.com/NASBP/c1d78960-916e-4da6-9bcd-6cd3d50b3ab7/UploadedImages/Industry/WorkingOnASubguardProject.pdf.

9 Andrew Zimmerman, Carl Bloomfield & Shane Riccio, *Contractor Default Insurance: A Nuanced Alternative to Performance Bonds* (May 10, 2013), http://www.grahamco.com/KnowledgeCenter/whitepapers/nuanced-alternative-to-performance-bonds/.

10 Lowell J. Notebloom, *Subguard® Subcontractor Insurance–What is it? Is it an appropriate alternative to surety bonds?* (2001), http://www.lorman.com/resources/an-alternative-to-performance-bonds-advantages-and-disadvantages-of-subcontractor-default-insurance-for-the-general-contractor-15813.

11 A recent federal court decision raises some concern that an SDI policy may be used as a funding scheme for the insured to recovery for a subcontractor's defective work claims. Pavarini Constr. Co. (Se) Inc. v. Ace Am. Ins. Co., 161 F. Supp. 3d 1227 (S.D. Fla. 2015). The *Pavarini* court recognized a key distinction between risks covered under CGL insurance and those covered under SDI. The CGL insured the owner and general contractor and covered subcontractors "against the risk of claims of property damage and bodily injury" while the SDI insured the general contractor "against the risk of subcontractor contractual default." *Id.* The decision left open the question of whether SDI should cover a subcontractor's defective work.

12 Andrew Zimmerman, Carl Bloomfield & Shane Riccio, *Contractor Default Insurance: A Nuanced Alternative to Performance Bonds* (May 10, 2013), http://www.grahamco.com/KnowledgeCenter/whitepapers/nuanced-alternative-to-performance-bonds/.

13 *Subcontractor Default Insurance vs. Performance Bonds: Do You Know the Difference?* General Insurance Services, http://www.genins.com/img/~www.genins.com/commercial%20lines%20articles/subcontractor%20default%20insurance%20vs.%20performance%20bonds%20do%20you%20know%20the%20difference.pdf.

14 *Id.*

15 This endorsement to the SDI policy often provides the owner access to the policy only in the event of general contractor insolvency. Otherwise, the owner's only recourse is under its direct contract with the general contractor or through a general contractor's surety. Douglas Schrift, *Subcontractor Default Insurance: Markets, Myths and Misconceptions, Contractor Default Insurance,* IRMI CONSTRUCTION RISK CONFERENCE (Nov. 10, 2015), https://www.irmi.com/docs/default-source/crc-handouts/2015-crc-handouts/subcontractor-default-insurance-markets-myths-and-misconceptions.pdf?sfvrsn=8.

16 Another endorsement entitled an Owner's Assignment Endorsement can provide that the SDI is assignable only in the event of the insolvency of the construction manager.

17 Douglas Schrift, *Subcontractor Default Insurance: Markets, Myths and Misconceptions, Contractor Default Insurance,* IRMI CONSTRUCTION RISK CONFERENCE (Nov. 10, 2015), https://www.irmi.com/docs/default-source/crc-handouts/2015-crc-handouts/subcontractor-default-insurance-markets-myths-and-misconceptions.pdf?sfvrsn=8.

18 Susan L. McGreevy, *Working on a Subguard Project: Loss of Protection for Subcontractors©* (2006), https://higherlogicdownload.s3.amazonaws.com/NASBP/c1d78960-916e-4da6-9bcd-6cd3d50b3ab7/UploadedImages/Industry/WorkingOnASubguardProject.pdf.

19 Peckar & Abramson, *An Alternative to Performance Bonds--Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor* (Apr. 30, 2014), http://www.lorman.com/resources/an-alternative-to-performance-bonds-advantages-and-disadvantages-of-subcontractor-default-insurance-for-the-general-contractor-15813.

20 Pavarini Constr. Co. (Se) Inc. v. Ace Am. Ins. Co., 161 F. Supp. 3d 1227 (S.D. Fla. 2015).

21 *Id.*

22 The best use of an SDI policy required the insured to be large and well-organized, have high annual dollar volume in subcontractors, have relationships with trusted trade subcontractors, and readiness to self-insure before "real" coverage is available for a loss. *Id.*

23 *Managing Subcontractor Risks of Non-Performance and Financial Failure: A Flash Guide to Subcontract Bonds and Subcontractor Default Insurance,* SURETY BOND QUARTERLY (Spring 2016), NASBP, http://suretyinfo.org/?wpfb_dl=172.

24 *See* Susan L. McGreevy, *Working on a Subguard Project: Loss of Protection for Subcontractors©* (2006), https://higherlogicdownload.s3.amazonaws.com/NASBP/c1d78960-916e-4da6-9bcd-6cd3d50b3ab7/UploadedImages/Industry/WorkingOnASubguardProject.pdf.

25 J. Brad Robinson, *Subcontractor Surety Bonding and Default Insurance: The Value (and Risk) of Using Both Resources,* SURETY BOND QUARTERLY (Spring 2016), NASBP, https://higherlogicdownload.s3.amazonaws.com/NASBP/bd33a733-16f0-4bbf-9ae0-8d97df85adac/UploadedImages/6-16/Brad%20Robinson%20Sub%20Surety%20Bndg%20Default%20Ins%20March%202016.pdf.

26 *Subcontractor Default Insurance vs. Performance Bonds: Do You Know the Difference?* General Insurance Services, http://www.genins.com/img/~www.genins.com/commercial%20lines%20articles/subcontractor%20default%20insurance%20vs.%20performance%20bonds%20do%20you%20know%20the%20difference.pdf.

27 Opinion Letter from Matthew K. Cashion, Jr., President of NASBP (June 9, 2003), on file with McGraw Hill Companies, Inc.

28 Douglas Schrift, *Subcontractor Default Insurance: Markets, Myths and Misconceptions, Contractor Default Insurance,* IRMI CONSTRUCTION RISK CONFERENCE (Nov. 10, 2015), https://www.irmi.com/docs/default-source/crc-handouts/2015-crc-handouts/subcontractor-default-insurance-markets-myths-and-misconceptions.pdf?sfvrsn=8.

29 J. Brad Robinson, *Subcontractor Surety Bonding and Default Insurance: The Value (and Risk) of Using Both Resources,* SURETY BOND QUARTERLY (Spring 2016), NASBP, https://higherlogicdownload.s3.amazonaws.com/NASBP/bd33a733-16f0-4bbf-9ae0-8d97df85adac/UploadedImages/6-16/Brad%20Robinson%20Sub%20Surety%20Bndg%20Default%20Ins%20March%202016.pdf.

30 Susan L. McGreevy, *Working on a Subguard Project: Loss of Protection for Subcontractors©* (2006), https://higherlogicdownload.s3.amazonaws.com/NASBP/c1d78960-916e-4da6-9bcd-6cd3d50b3ab7/UploadedImages/Industry/WorkingOnASubguardProject.pdf.

31 Andrew Zimmerman, Carl Bloomfield & Shane Riccio, *Contractor Default Insurance: A Nuanced Alternative to Performance Bonds* (May 10, 2013), http://www.grahamco.com/KnowledgeCenter/whitepapers/nuanced-alternative-to-performance-bonds/.

32 G. Scott Walters, *SDI Insured Must Shoulder Burden to Pursue Claims Against CGL Policy,* SURETY BOND QUARTERLY (Spring 2016), NASBP, http://www.suretybondquarterly.org/2016/04/22/sdi-insured-must-shoulder-burden-to-pursue-claims-against-cgl-policy/.

33 See *id.* and discussion of *Pavarini* case therein.

34 *See* Charles L. Bowman & Co. v. Erin, 468 F.2d 1293 (5th Cir. 1972) (holding that "matters bearing upon the execution, validity, interpretation, and obligations of contracts are determined by the laws of the place where the contract is made"); Bank of N.Y. Mellon v. SACE S.P.A., No. 10 Civ. 2510, 2011 WL 102728, at *5 (S.D.N.Y. Jan. 6, 2011) (holding that assignee of an insurance contract is bound by the policy's forum-selection clause); American S.S. Owners Mut. Prot. & Indem. Ass'n, No. 10 Civ. 8033, 2013 WL 1245451 (S.D.N.Y. Mar. 26, 2013) (holding a non-signatory entitled to receive benefits from an insured's policy is bound by the insurance contract's choice of law).

35 Travelers Indem. Co. v. Israel, 354 F.2d 488, 490 (2d Cir. 1965); Bioscience West, Inc. v. Gulfstream Prop. & Cas. Ins. Co., 185 So. 3d 638 (Fla. Dist. Ct. App. 2016); see also Beazley Ins. Co., Inc. v. Ace Am. Ins. Co., 150 F. Supp. 3d 345, 358-59 (S.D.N.Y. 2015) ("[t]o the extent policies purport to limit post-loss assignments, 'such assignments are contrary to the public policy of New York'"); NC Venture I, L.P. v. Valley Forge Ins. Co., 20 Misc. 3d 1133 (N.Y. Sup. Ct. 2008) ("While it is settled law in New York that claim proceeds may be assigned after a loss . . . where the policy forbids assignment before a loss, that condition will be upheld.").

36 *See* Lachmar v. Trunkline LNG Co., 753 F.2d 8, 9-10 (2d Cir. 1985) ("Under New York law . . . the assignee of rights under a bilateral contract is not bound to perform the assignor's duties under the contract unless he expressly assumes to do so."); Citizens Prop. Ins. Corp. v. Ifergane, 114 So. 3d 190 (Fla. Dist. Ct. App. 2012) ("Although [the assignor] assigned her right to *benefits* under the policy, she did not assign to [the assignee] her *obligations* under the policy.").

37 The presence of SDI coverage could also influence the surety's ability to collect money for past and submitted claims. Careful review of the policy language must be emphasized to ensure the surety is taking actions that comply with the policy guidelines so coverage remains available.

38 The surety hits a roadblock if the principal general contractor's subcontractors do not qualify or are not allowed to enroll in the completing contractor's SDI program. Even if they do qualify for purposes of the SDI program, however, the completion contractor may view the already enrolled subcontractors are less than quality subcontractors and not want to continue using them on the job (again, revealing an unfavorable result of prequalification being taken away from the responsibility of the surety).

39 Coverage for defective work may run for the duration set by the statute of repose.

40 Peckar & Abramson, *An Alternative to Performance Bonds–Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor* (Apr. 30, 2014), http://www.lorman.com/resources/an-alternative-to-performance-bonds-advantages-and-disadvantages-of-subcontractor-default-insurance-for-the-general-contractor-15813.

41 *Subcontractor Default Insurance vs. Performance Bonds: Do You Know the Difference?* General Insurance Services, http://www.genins.com/img/~www.genins.com/commercial%20lines%20articles/subcontractor%20default%20insurance%20vs.%20performance%20bonds%20do%20you%20know%20the%20difference.pdf.

42 It is also noteworthy that SDI policies grant the insured broad discretion to determine whether a subcontractor is in default of its contractual obligations in the first place. Michael S. McNamara, *Subcontractor Default Insurance–A Modest Rebuttal,* GRAVEL2GAVEL CONSTRUCTION LAW BLOG (Mar. 1, 2016), http://www.gravel2gavel.com/2016/03/subcontractor-default-insurance-modest-rebuttal.html. Although what actions or inactions constitute a "default" are often the same between the two risk alternatives, the implication is that general contractors may be more or less inclined to declare a default depending on the status of the project and without the third-party surety to look to cover the loss.

43 J. Brad Robinson, *Subcontractor Surety Bonding and Default Insurance The Value (and Risk) of Using Both Resources,* SURETY BOND QUARTERLY (Spring 2016), NASBP, https://higherlogicdownload.s3.amazonaws.com/NASBP/bd33a733-16f0-4bbf-9ae0-8d97df85adac/UploadedImages/6-16/Brad%20Robinson%20Sub%20Surety%20Bndg%20Default%20Ins%20March%202016.pdf.

feature

Bottom Line Protection with Job Cost Accumulation & Allocation

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BY R.A. BOBBI HAYES

A CONTRACTOR'S BOTTOM LINE is directly affected by errors in bidding, estimating, and job profit realization; job cost accumulation and allocation are key.

Our CPA firm works with many construction contractors of various sizes and degrees of business sophistication. Over the years, we have found that appropriate handling of job indirect costs is one of the weakest areas typically found in a contractor's accounting system. Not understanding either the components that should be included in indirect costs or how they relate to a job can lead to substantial errors in bidding and estimating and in job profit realization. This is one of the most significant areas where a contractor can learn tools to directly affect its bottom line.

Accounting is governed by a framework known in the United States as generally accepted accounting principles (GAAP). Recording and reporting accounting transactions in a consistent manner within this GAAP framework leads to information that is meaningful, useful, and appropriate and that is comparable to other information (for example, to a particular company's results in different operating periods or to other companies operating in the same industry). In addition, recording and reporting costs consistently support the proper calculation of revenue for each contract.

In accounting, we look to formal pronouncements that provide guidance about such areas as the type of costs that should be included in accumulating costs for a particular contract. Major guidance for construction contractors concerning job cost accumulation is found in the technical pronouncement Financial Accounting Standards Board (FASB) ASC 605-35, which specifically provides guidance on how to account for contracts of commercial businesses that operate completely or partially in a contracting business. The guidance in this area had its origins in a pronouncement known as SOP 81-1, Accounting for Performance on Construction-Type and Certain Production-Type Contracts.

The following are some specific sections of FASB ASC 605-35, which are the areas that pertain the most to this discussion:

25-32 Contract costs shall be identified, estimated, and accumulated with a reasonable degree of accuracy in determining income earned. At any time during the life of a contract, total estimated contract cost consists of both of the following components:

a. Costs incurred to date

b. Estimated cost to complete the contract

25-33 An entity should be able to determine costs incurred on a contract with a relatively high degree of precision, depending on the adequacy and effectiveness of its cost accounting system. The procedures or systems used in accounting for costs vary from relatively simple, manual procedures that produce relatively modest amounts of detailed analysis to sophisticated, computer-based systems that produce a great deal of detailed analysis. Despite the diversity of systems and procedures, however, an objective of each system or of each set of procedures should be to accumulate costs properly and consistently by contract with a sufficient degree of accuracy to assure a basis for the satisfactory measurement of earnings.

25-34 Contract costs are accumulated in the same manner as inventory costs and are charged to operations as the related revenue from contracts is recognized. Contract costs generally include all direct costs, such as materials, direct labor, subcontracts, and indirect costs identifiable with, or allocable, to the contracts. However, practice varies for certain types of indirect costs considered allocable to contracts.

25-37 A contracting entity shall apply the following general principles in accounting for costs of construction-type and those production-type contracts covered by this Subtopic . . . their application requires the exercise of judgment.

a. All direct costs, such as material, labor, and subcontracting costs, shall be included in contract costs.

b. Indirect costs allocable to contracts include the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls. Methods of allocating indirect costs should be systematic and rational. They include, for example, allocations based on direct labor costs, direct labor hours, or a combination of direct labor and material costs. The appropriateness of allocations of indirect costs and of the methods of allocation depend on the circumstances and involve judgment.

DIRECT COST AND ITS COMPONENTS

Direct costs for a construction contract are the easiest to determine because you can associate them directly with a specific contract and they wouldn't apply to a multitude of contracts. Direct costs are usually separated and recorded in certain categories, which are consistently used for most contractors. These categories are:

- Labor
- Materials
- Outside equipment rental
- Subcontractors
- Other or miscellaneous unique costs

Labor

Direct labor can also have several components, and not all contractors use the same criteria. What is most important is that a particular contractor decide what labor is recorded as unique to a specific job and what labor is recorded as supporting multiple jobs (therefore, as indirect labor) and then apply that consistently. Direct labor includes direct wages and prevailing wage fringe benefits of:

- Construction field workers
- Field supervisors and foremen

Other costs related to direct wages are usually treated as indirect costs rather than direct costs:

- Payroll taxes, workers' compensation insurance and general liability insurance, fringe benefits (such as health insurance, retirement plans, and uniforms)

Materials

Materials that are used directly on a specific contract should include all related costs, such as freight. Unused materials at the end of a job should be removed from the direct cost and recorded as inventory to be issued on a future job (unless very minor in amount). Bulk materials purchased to be used on multiple jobs (often purchased in bulk to obtain price advantages) should be recorded as inventory and moved from inventory to direct job cost when issued on a job. Miscellaneous material items may be included in indirect costs if they are difficult to account for specifically (nails, screws, etc.)

Outside Equipment Rental

Short-term, outside equipment rental used for a particular job should be directly costed to that job. Outside equipment rentals that are on multi-month contracts should be considered for inclusion in an equipment cost pool, along with contractor-owned equipment.

Subcontractors

Costs from specific subcontracts should be recorded directly to the related job. A contractor should have a system in place to track specific subcontracts for each job, including the ability to track invoices received against each individual subcontract. Attention should be paid to flow-down provisions from contracts to subcontracts, especially in the area of retainage. If retainage is being withheld on subcontract payables, then the entire amount of the payable should be recorded as an expense and the payable broken down into its two components: accounts payable and retainage payable.

Other or Miscellaneous Direct Costs

Miscellaneous direct costs are items that can be specifically traced to a unique contract (in other words, it doesn't benefit more than that one contract). Examples are:

- Permits
- Surety bonds
- Job site utilities
- Temporary fencing
- Specific job travel, lodging, meals (or per diem)
- Professional services unique to a job that wouldn't be considered in the category as a subcontractor (for example, architecture, engineering, design, inspection, testing)

What About Sales or Gross Receipts Tax?

A contractor has two choices on how to record sales or gross receipts taxes on construction contracts. First, billings can be recorded as revenue to a specific contract net of gross receipts tax, and gross receipts tax is recorded only as a liability to be paid based on whatever method a contractor uses to report the tax (as billed or when collected). Second, billings can be recorded as revenue to a specific contract, including sales or gross receipts tax. If this is the method used, then the corresponding sales or gross receipts tax should be recorded as a direct cost to the specific contract.

A contractor should consistently apply whichever method he or she uses to all jobs. This is sometimes difficult based on the provisions of a particular contract and how accounting software may record the sales tax from an invoice.

INDIRECT COST COMPONENTS

Indirect job cost is the area that we find gives contractors the most problems. The numbers change every week, every month, every quarter. How is a contractor supposed to handle these variations? Indirect job cost is harder to understand, track, and apply. Failure to understand indirect cost components leads to errors in bidding, which often turns into unprofitable jobs. Because indirect cost is primarily subjective, the contractor must decide what should be included. Once a contractor figures out what should be included, then the contractor must determine how it should be allocated or applied to a specific job.

Indirect costs or overhead generally falls into three distinct categories:

- Labor burden or overhead
- Internal equipment overhead
- Other indirect overhead

Indirect costs or overhead does not include costs considered to be in the category of general and administrative costs (such as general office expenses, office personnel, office supplies, office building rent, etc.), which do not relate to the actual construction activity.

Many contractors start out only using one large general pool to accumulate and allocate indirect costs. Over time, as a contractor grows in experience and understanding of this area, there is usually a movement towards separating the varied elements and their method of allocation. There is no limit to the number of cost pools that can be designed; the important concept is consistency of theory and allocation in each pool.

Labor Burden or Overhead

The major categories of costs to include are the following:

- Payroll taxes (employer paid portion of FICA, Medicare, federal unemployment and state unemployment taxes)
- Workers' compensation insurance
- General liability insurance (labor burden if based on payroll exposure; however, sometimes general liability is based on sales exposure and put to other indirect overhead)
- Support labor (such as general project management or supervision)
- Health insurance
- Retirement benefits
- Vacation and holiday pay
- Training

A CONTRACTOR'S BOTTOM LINE IS DIRECTLY AFFECTED BY ERRORS IN BIDDING, ESTIMATING, AND JOB PROFIT REALIZATION; JOB COST ACCUMULATION AND ALLOCATION ARE KEY.

- Other miscellaneous items (such as uniforms that only exist because of field labor)

Depending on the sophistication of the accounting software used and the accounting personnel supporting the contractor, some areas of labor burden are often recorded as direct costs to contracts. These costs follow the specific labor dollar recorded to the specific contract. The most common items that are recorded as direct costs include:

- Payroll taxes
- Workers' compensation insurance
- General liability insurance

Other costs as described previously would still be a part of an indirect labor cost pool.

Indirect costs specifically associated with labor should be allocated to jobs based on the direct labor dollars recorded to a specific job. The average labor burden percentage per dollar of direct labor should be projected for any given year (or other period, as long as the assumption is tested several times during that period based on actual results). Having this information frequently tested supports a contractor, providing the individuals who are estimating and bidding work have the most current information available.

Internal Equipment Overhead

Contractors usually take a varied approach to equipment leasing or ownership. Some contractors prefer to own as little equipment as possible and rely on renting the specific type of equipment that may be needed for a job. Other contractors prefer to make a more substantial investment in owning or leasing equipment, especially for those pieces used on a consistent basis in their contracting operation. Contractors should recognize that the costs of leasing or owning equipment include support costs to keep the equipment in good operating status, in additional to properly managing risk with insurance.

Equipment and vehicle costs that should be maintained in an overhead cost pool include the following:

- Depreciation (make sure that depreciable lives and methods are appropriate for each piece of equipment or vehicle, and consistently applied)
- Repairs and maintenance, including parts
- Personal property and other taxes
- Insurance (inland marine, vehicle insurance)
- Shop labor (and its own associated labor burden)
- Interest (sometimes all interest is treated as general and administrative expense, not indirect job cost)
- Fuel and oil (sometimes fuel is recorded as a direct cost to a specific contract)

The method used to allocate equipment and vehicle costs to a specific job once again depends on the sophistication of the contractor, its accounting software capability, and the capability of its accounting personnel.

Smaller contractors usually allocate their pool of equipment and vehicle costs as a percentage related to the direct labor dollar associated with a specific job. This usually has to be projected for a period of time so that the contractor has sufficient information to use in its bidding and estimating process (same as the labor burden pool discussed previously). Unless the contractor has few types of equipment, allocating an entire pool of equipment or vehicle costs in this manner can lead to substantial distortion of job costs. For example, perhaps a specific job used more expensive equipment than another job. Each job would bear the same weight of equipment cost. The job that used the more expensive equipment would be advantaged over a job that used less expensive equipment.

Larger contractors, supported by their accounting software, can treat each individual piece of equipment (or category of equipment, such as excavators) as its own cost center, much like a job. They usually allocate equipment use to a specific job by recording specific hours of use by field labor to that job, using hourly rental rates. Specific costs related to that piece of equipment, or category of equipment, is recorded to the individual cost center (for example, parts, repairs, insurance, depreciation).

Hourly rental rates are developed using a variety of sources. Many use local external rental rates, discounted for external profit. Some develop internal equipment rates using a consistent rate development approach (for example, projecting total cost for a piece of equipment over a period of time, divided by projected use) to get an hourly cost rate. Others use an external source of information, such as Equipment Watch (equipmentwatch.com), which produces the Rental Rate Blue Book (now known as the Cost Recovery Book). This is a service that can be subscribed to online, giving access to most up-to-date costs. In addition, certain government agencies have approved the use of this resource on federally funded projects, including force account work.

What to do with ending variances between equipment cost rates applied and actual equipment costs and idle equipment? Because all methods of equipment cost allocation use estimated rates or percentages, it is usual to have a situation at year-end of under- or over-allocated equipment costs. This variance should be applied proportionately to jobs. Some contractors apply the variance entirely to completed contracts; however, we believe that distorts contracts in process. The costs of equipment that has remained idle for a significant period of time, including depreciation and insurance, must nevertheless be included in the overall allocation of indirect costs to jobs. If a piece of equipment is idle for an entire year, there is support in accounting principles to suggest that its period of depreciation can be lengthened by one year (for example, if being depreciated over 10 years, the life can be increased to 11 years). Depreciation cannot, however, just be omitted for one year.

Other Indirect Overhead

Other miscellaneous indirect job costs should also be accumulated and allocated to jobs on a periodic basis. These costs include, but are not limited to, the following:

- Small tools and general job supplies
- Safety programs and supplies
- Drug testing programs
- Shop and yard costs (such as shop/yard rental and utilities)
- Items provided to support and field personnel (such as mobile telephones or other devices or tools)
- Quality control programs
- General liability insurance (if not based on payroll exposure)
- Other insurances (such as umbrella, builders' risk, etc.)
- Ways to allocate indirect costs

GAAP allows for several approaches to allocate overhead costs to jobs:

- Direct labor costs
- Direct labor hours
- Combination of direct labor and material costs

There are no other methods allowed under GAAP. Whatever system a contractor uses, it should be systematic, logical, and applied consistently from year to year.

Ensuring that careful attention is paid to the components of indirect costs and an appropriate, consistently used base for allocation is key to improving a contractor's opportunity to both control costs and improve its bottom line.

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feature

Inside the AIA's New Insurance and Bonding Contract Exhibit

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BY TODD R. REGAN

ENSURING THAT THE necessary insurance coverages and bonding are in place for a construction project is one of the most important, and at times easily overlooked, aspects of the construction contracting process. Oftentimes, consideration of the necessary insurance coverages, and who will be responsible for obtaining them for a project, can be treated as a mere afterthought. The American Institute of Architects' (AIA) new Insurance and Bonds Exhibit seeks to bring these considerations to the forefront.

As discussed in Kenneth Cobleigh's article [http://www.nxtbook.com/naylor/SBPQ/SBPQ0217/index.php?startid=24#/24] in the Summer 2017 edition of the NASBP *Surety Bond Quarterly* magazine, the AIA has recently issued revised versions of its A201 "family" of construction agreements, a process it undertakes once a decade. Most surety and insurance professionals will be quite familiar with the A201 suite of documents, as they are one of the most commonly used set of industry forms.

A significant change enacted by the latest revisions was the creation of a separate Exhibit to the contract forms setting forth the insurance and bonding requirements. In contrast, under the prior version (most recently the A201-2007), these requirements were contained deep within the A201 General Conditions of the Contract for Construction at Article 11.

THE NEW EXHIBIT EXPANDS UPON THE PRIOR INSURANCE REQUIREMENT AND PROVIDES A WIDER MENU OF COVERAGE OPTIONS FOR THE PARTIES TO CHOOSE FROM. THIS IS A SIGNIFICANT CHANGE THAT REFLECTS THE IMPORTANCE OF EARLY CONSIDERATION OF THE ROLE TO BE PLAYED BY INSURANCE AND BONDING AS A RISK TRANSFER MECHANISM BETWEEN THE PARTIES.

The new Exhibit expands upon the prior insurance requirement and provides a wider menu of coverage options for the parties to choose from. This is a significant change that reflects the importance of early consideration of the role to be played by insurance and bonding as a risk transfer mechanism between the parties.

Notably, although the bonding requirements are also shifted to the new Exhibit, the most significant changes are to the insurance provisions. The bonding requirements in the A201 family of documents remain largely unchanged, and it should be noted that these revisions do not modify the language of the popular AIA A312 Performance Bond and Payment Bond, which was last revised in 2010. However, it is notable that both the revised Article 11 of the A201 General Conditions and the new Insurance and Bonding Exhibit contain new language expressly requiring that surety bonds be obtained only from a surety company that is lawfully authorized to issue bonds in the jurisdiction where the project is located. This new requirement, which was added at the suggestion of the NASBP, will help ensure that required bonds are backed by companies that are adequately capitalized and that the parties will be protected as they intended. In addition, the revised language now expressly calls for the use of the A312 bond form.

According to AIA, the move to a separate Exhibit was motivated, at least in part, by a desire to facilitate the transmittal of the form to the parties' insurance/bonding professionals for review. Rather than having to wade through a thick set of contract documents, the concept was to create a concise, standalone document for easier identification of the required coverages. While the use of a separate Exhibit may indeed make it easier to spot the required insurance coverages, bond producers and surety underwriters will, of course, still need to review other key contract terms, such as scope, price, waivers of consequential damages, indemnification provisions, no-damages-for-delay clauses, and liquidated damages provisions, among others.

Another reason cited by the AIA for the shift to use of the insurance Exhibit was to give the agreements flexibility to incorporate and adopt changes and developments in the insurance products used in the construction industry and to allow for future changes without requiring additional edits/modifications within the contract documents. This concept reflects the trend of changing availability of insurance products and evolving policy language. On the other hand, the fact that the insurance provisions are now set forth on a separate Exhibit would seem to increase the risk that the parties may inadvertently omit it altogether.

The Exhibit seeks to provide a user-friendly check-the-box menu of insurance coverages for the parties to choose from, depending on type of and complexity of project. The Exhibit includes a list of traditionally required coverages as well as an expansive list of optional coverages. The intent here appears to have been to draw attention to additional types of coverages that the parties may not otherwise have considered.

The Exhibit requires the owner to obtain property insurance written on a builder's risk "all-risks" completed value or equivalent policy form sufficient to cover the total value of the project. In addition, the owner's property insurance must be maintained through completion and correction of the work through the contractor's one-year warranty period, and not merely through the date of final payment as required by the prior language. In addition, in the case of a renovation or remodeling project, the form also requires the owner to purchase property insurance covering existing structures. Although the Exhibit (like the prior version of the A201) contemplates that the owner will be responsible for obtaining the property insurance, it provides an option for shifting this burden to the contractor.

The check list of optional coverages that the parties may agree will be purchased by the owner includes loss of use, business interruption, delay in completion insurance and cybersecurity insurance, among others.

Notably, the new Exhibit prohibits exclusions to the owner's property insurance for loss from fire, exposition, theft, vandalism, malicious mischief, collapse, earthquake, flood, or windstorm, in order to ensure coverage for events that may arise during the course of a project. It also requires coverage for ensuing loss or resulting damage from error, omission, or deficiency in construction means and methods or materials.

For the contractor, the Exhibit requires the purchase of general liability (including completed operations coverage), workers compensation, auto liability, and employer's liability insurance, which must be maintained through the time period for the contractor's correction of the work. Like the owner's property coverage, the Exhibit contains a lengthy list of prohibited policy exclusions for the contractor's general liability coverage, which are set forth in § A.3.2.2.2.

As with the owner's property coverage, the Exhibit contains a host of additional coverages that parties may agree that the contractor will obtain, including professional liability, pollution liability coverage, and property coverage for property owned by the contractor and used on the project, among several others.

Although many of the key insurance terms now appear in the new Exhibit, some important provisions can still be found in the revised Article 11 of the A201. The clauses remaining in Article 11 mainly concern the adjustment of claims, the consequences for the failure to procure and maintain the required coverages, and waivers of subrogation.

Whereas the prior version of the A201 called for the contractor to furnish certificates of insurance that required the insurer to provide the owner notice of cancellation, the revised language shifts this notice obligation to the contractor. This change was driven by the reluctance of insurers to undertake this notice obligation. Similarly, the owner is obligated to provide notice to the contractor in the event that any required property insurance is not obtained or is canceled. In either case, the party receiving the notice of cancellation is permitted to stop the work until the lapse in coverage is cured. In the event that the owner does not procure the required property insurance, or it is canceled, the contractor also has the right to procure the required insurance itself and seek reimbursement for these costs through a change order. Under such circumstances, the contractor is also entitled to an equitable adjustment to the contract time and sum from any resulting delays. Furthermore, in the event of a lapse in insurance, the owner waives any claims against the contractor and its subcontractors that would have been covered by property insurance that the owner allowed to lapse.

In addition, the revised Article 11 contains new provisions concerning the adjustment and settlement of losses covered by property insurance. It continues to provide that losses will be adjustable and payable to the owner, who will serve as a fiduciary for the other parties. It now also provides a formal mechanism pursuant to which the contractor can dispute the owner's proposed allocation of the insurance proceeds.

With respect to waivers of subrogation, the revised Article 11 extends the waiver of subrogation to the owner's "Separate Contractors" who might be performing work on the property. In addition, the waivers of subrogation are no longer required to be included in a policy endorsement or otherwise; instead, the language of Article 11 simply provides that the required contractual waiver of subrogation cannot be precluded by the policy form.

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The Calm After the Storm: Managing Disaster Response Contracts

BY W. BARRON A. AVERY AND WILLIAM B. O'REILLY

WHEN A DISASTER strikes, federal, state, and local authorities turn to the private sector to quickly mobilize the resources and expertise needed to effectively respond and rebuild. With more than $15 billion in relief funds already approved for the response to Hurricane Harvey and more funding appropriated to assist with the recovery from Hurricanes Irma and Maria, contractors can expect myriad opportunities to participate in the effort to rebuild vast swaths of Texas, Louisiana, Florida, and Puerto Rico. With such large sums of money being doled out in a short time, it is easy for the government to lose track of how effectively it is spending that money, but that does not relieve contractors of their own obligations to account for the funds. Despite the fast pace of awards and performance, and hazy, often fluid needs, ordinary procurement rules remain generally applicable in disaster recovery situations. Consequently, contractors who fail to adequately assess the requirements associated with their contracts may face significant, unrecoverable losses or, worse, monetary claims by the government, as disaster recovery contractors have learned the hard way in the years since Hurricane Katrina and Superstorm Sandy.

In December 2016, the Civilian Board of Contract Appeals rejected a construction contractor's claim for more than $4 million associated with delays and cost overruns allegedly incurred in the construction of a Louisiana breakwater after Hurricane Katrina due to differing site conditions. The board found that a modification issued by the government after the storm warned the contractor that conditions had changed and may remain "dynamic." Because the government had made no assurances regarding the continued accuracy of certain historical data provided in the solicitation and the conditions encountered by the contractor were not materially or unforeseeably different from those suggested by the government, the board found that the contractor's expectation of specific conditions based on the solicitation was unreasonable.

More recently, in March 2017, the United States Court of Federal Claims rejected a fuel supplier's claim for nearly $200,000 in costs incurred due to alleged changes and breaches by the government on a contract for the delivery of bulk fuel to airports in the New York area in the wake of Superstorm Sandy. The contractor argued that changes in the delivery method prescribed by the original Invitation for Bids constituted a cardinal change for which the contractor was entitled to compensation. However, the court, relying on email correspondence between the parties prior to contract award, found that the government had altered the terms of its offer, binding the contractor to the changed delivery method. Worse still for the contractor, due to the shoddy recordkeeping that precipitated its claim, the government filed multiple counterclaims alleging the contractor's claims were fraudulent, threatening a total liability of more than $200,000. As of this writing, those claims remain pending.

As these cases show, contracting in the wake of a natural disaster is fraught with risks, from escalating cost experiences in uncertain conditions to recordkeeping difficulties under impending deadlines that may prove costly in the future. However, these cases also suggest certain steps that contractors can take to protect themselves. First, through the use of price-adjustment clauses and other risk-sharing provisions in contracts where the scope of work is impossible to know at the outset, contractors can mitigate the likelihood of incurring losses. Second, by regularly communicating with the government both before and during performance, contractors can best understand the work to be performed and adapt their approach accordingly. Finally, by maintaining a comprehensive written record, contractors can substantiate their own performance experiences, improving the strength of any future claims they may need to file while insulating themselves from allegations of false, inflated, or fraudulent claims. By proactively addressing these risk factors, contractors can position themselves to make the most of the opportunities to come.

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Avery and O'Reilly's government contracts practice includes the representation of contractors in bid protests, claims litigation, investigations, and regulatory compliance matters.

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Practical Tools
to Help Jump-Start Your Company's Cyber Plan

Part 2 of 2

BY LINN F. FREEDMAN AND JAMES CRIFASI

IN THE MONTHS since our first article appeared, it's evident from the stories we hear that cyberattacks are coming faster than ever. An often asked question is "Where should we start?" or "What do I do first to prevent an attack?" This can be answered with the story of the last security incident with which we were asked to assist. It started with the panicked call asking for help after the company realized it had been hacked.

The urgent questions posed included: "How could the hackers have gotten in? What failed? How did our IT let this happen?"

The answers were, unfortunately, very simple. Executives in the company had decided that good security practices and recommendations made by IT should apply to everyone but themselves. In the course of the investigation, we heard the dreaded words of the CEO, "I'm too busy to change my password." The company's issues went downhill from there as we discovered that the passwords were not only old, but also were being used for personal and social media accounts.

Credential theft and loss happen constantly. The media reports on the big compromises but not the thousands of small events where credentials are stolen and then bartered on the black market. This means that the chance of your old passwords floating around the internet is actually quite high. With the availability of machine learning, making use of these passwords requires virtually no effort. And the answer to "how could they have gotten in?" is simply that they logged in as the executive who was too busy to change his password using his old password. Logging in as the executive set off no alarms, tripped no sensors, and violated no IT protocols. They had the executive's keys and just unlocked the door the same way the executive does.

The worst part of these incidents is that they are completely avoidable. Two basic cybersecurity concepts to start with are:

1) Assume passwords have been compromised; and
2) Security must apply to everyone in the company from the top down.

Those with the highest rank and privilege have, by default, the most access to data and therefore pose the greatest risk to the organization. Executives often are the riskiest members of the organization, because they sometimes believe the rules don't apply to them, and, therefore, they often have the least security protection because security personnel are unable to insist that they follow the same protocols.

Security must be set up to protect your highest risk assets! It is truly staggering the number of incidents, breaches, downtimes, hacks, malwares, and virus outbreaks that would never have happened if these two tenets of security had been followed.

Here are some cybersecurity "Getting Started Actions" you can take:

Assume the bad guys have your password.

Ask the question to your security team, and do so bluntly: "If someone has my password, how do you keep them out?" The answer to this should be very quick and simple. The answer is two or multifactor authentication. At a more sophisticated level, your IT team may be using behavioral analytics or conditional access systems. Any of these make for good security defenses and are most effective when they can be described and articulated quickly and in a manner that is easy to understand. This is the simplest attack vector, yet the hardest to notice. It is one of the reasons that a breach can go undetected for hundreds of days. Much of your security defenses should be based on this concept.

Ask your security team questions; do not let exceptions be your downfall.

Do you make policy exceptions for IT or executives? The answer should be no, especially IT and executives, as they pose a high risk to the organization. No one should be the administrator of their PC, including IT personnel and there should be no exceptions to this. As a business leader always ask the questions, "Does this procedure apply to everyone? Are there any exceptions?" There are weak spots in any environment, so ask where they are and prompt the question "Am I a weak spot?" Give security teams the opening to change the status quo, as it may save you from disaster.

Implement an ongoing and creative education campaign.

Every organization should have a formal internal and external security education campaign. One of the top security defenses is formal and regular training of all employees. It should include at least the following three areas:

- Phishing and spam training and testing
- Training on company specific security policies, procedures, programs and concerns
- Training on how security can benefit the individual both at work and at home. It is helpful to employees to teach them about their personal security and how it transfers to the security of the company.

Be creative with security education. Face-to-face training is the most effective, but it can't stop there—once and done is not sufficient. Effective security training delivers the message when the employees are engaged, and it continually reiterates good cyber hygiene. Employees do care about the company data; many times they just are unaware that some of their practices are risky. Make them the stewards of your information and part of the solution. They will be grateful for the trust and responsibility.

Require all employees to receive data privacy and security training at least annually, with frequent follow-ups. Too often there is the assumption that everyone knows what the "right" thing to do is. While positive, we find that this leads to a false assumption of security and safety. Often the default behavior is: "If no one has mentioned it, it must be okay." All employees need security training and to be shown what "right" means. Educate employees to identify what data is dangerous and how to handle it. Grade your level of success for security training as well as your systems. Employees are your highest risk. Let them know it, and empower them to be part of the solution.

A well-run organization has down time and must patch vulnerabilities.

Do you allow IT to have a regular monthly down time so systems are up to date? You wouldn't run construction equipment constantly without servicing it, would you? Many of the recent newsworthy vulnerabilities and exploits had resolutions well before the issues became evident. There is no perfect system; all systems will have bugs and problems. However, implementing patches and proper maintenance is a critical business process. Today's unimportant patch may be tomorrow's exploit savior!

Disaster recovery and back up is vital to cybersecurity.

It is likely that, no matter the defenses, at some point you will need to recover from an incident. Perhaps from ransomware, maybe a virus, an employee could make a mistake, your cloud server could be hacked, or your server room could flood. No matter the issue, the ability to recover is dependent on your disaster recovery or back up plan.

Your vendors continue to be a risk to your organization. Ask vendors the following:

- How do you protect client data? One of our favorite places to find risky or sellable data is data exports and mailing lists sent to outside venders. They tend to be simple, portable, and often contain more information than the vendor needs for the purpose for which the data is being sent.
- Do you routinely manage, monitor, and analyze the collection of logs (including user activity, network activity, performance data, application activity, and/or flow data) in your infrastructure? This is important to monitor the transmission of data to vendors and to determine the minimum amount necessary for the purpose is transferred to the vendor.
- What is your process to proactively detect/analyze invalid user access, or any anomalies in applications or network traffic in your organization?
- Do you currently conduct security assessments, such as penetration tests, on a regular basis, and do you require your vendors to do the same?
- How do you address any security gaps with vendors that you might discover?

Ask your executive team the following:

- Do you know where all your sensitive data resides (paper and electronic)? This includes all employee information–Social Security numbers, contact information, compensation information, background check information, etc. and customer information.
- Do you know which employees have access to the most sensitive data in the organization?
- Do you limit/monitor employee access to sensitive data on a "need to know" basis?
- Do you require all employees to receive data privacy and security training? All employees should receive training and sign acknowledgments that they attended the training.

In the end, true security is based on the ability of the security team and the executive team to have an honest and open dialogue. The teams must be able to discuss security issues, efforts, and gaps with clarity and absolute transparency. This is only possible when the executives are willing to follow the two tenets of cybersecurity described above.

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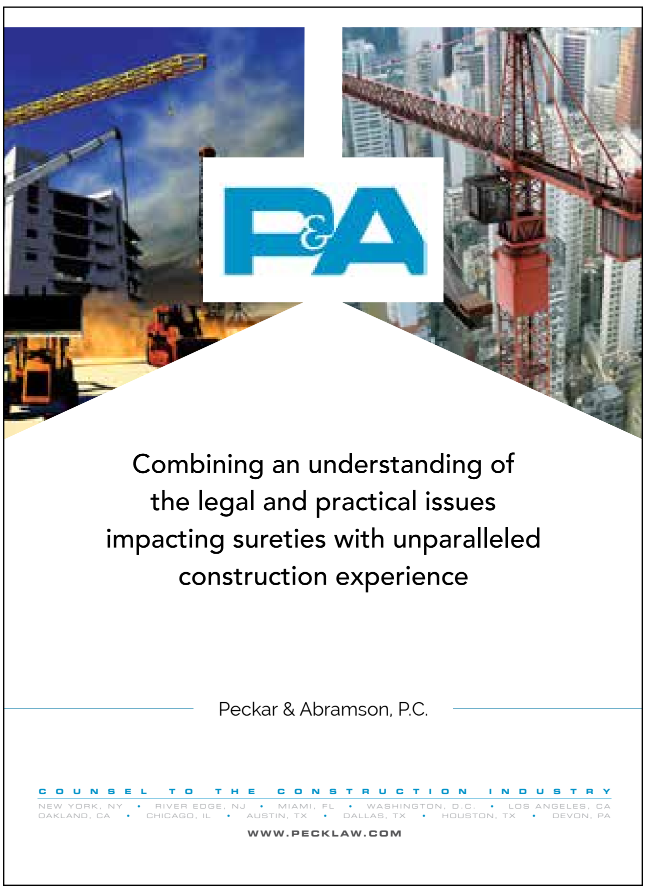

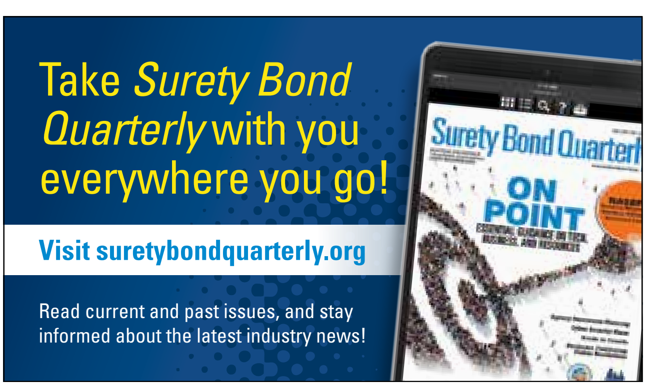

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