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CONSTRUCTION
ALERT

The Ins and Outs of Surety Bonds:
The Insolvent Surety

By Carl Anthony Maio

Commercial, and sometimes residential, construction requires a contractor to obtain a surety bond to guarantee performance leading to the successful conclusion of a project. Upon that occasion, a general contractor will obtain a surety bond from an authorized underwriter.

In basic terms, a surety bond is a contract under which one party (surety) guarantees the performance of certain obligations of the second party (principal) to a third party (obligee). Generally in the commercial context, and more specifically for public entity projects, construction contractors provide the project owner with a bond guaranteeing that it will complete the project by a specified date set forth in the construction contract in accordance with all plans and specifications. Usually, one or more in any combination of the following three types of bonds are underwritten to secure the contractor's performance:

1. **Bid Bonds** - Issued in conjunction with construction bidding processes. This bond acts as a guarantee that, if awarded the contract based on the bid submitted, the contractor will enter into a contract to perform the work at the price quoted. If the contractor declines to enter into a contract to perform the work at the agreed upon price, the bid bond will reimburse the obligee (owner) the difference between the defaulting contractor's bid and the next lowest bid, up to the penal sum of the bond.

2. **Performance Bond** - This bond guarantees that the contractor will perform the work in accordance with the construction contract. The purpose is to protect the owner from financial loss up to the penal sum limit of the bond should the contractor fail to fulfill its contractual obligations.

3. **Payment Bond** - This last bond form guarantees that suppliers and subcontractors will be paid for materials and labor furnished to the contractor. A project owner generally insists upon a payment bond, that upon completion, the project is free of contractor mechanic's liens.

The American Institute of Architects (AIA) is the most common source of standard construction contracts and bond forms defining the responsibilities of contracting parties with respect to indemnification in the purchase of insurance coverage. In this context, this Alert will not address contractor's risk insurance or contractor's professional liability insurance. Nor will this Alert speculate upon the liability of a producer who places a bond with an underwriter whose financial strength rating is less than "secure."

An essential part of the surety's underwriting process is the preparation and execution of a General Agreement of Indemnity (GAI). The GAI is akin to a personal indemnification guaranty. In short, this is a two party contract between the surety and the principal (contractor), that if the principal fails to perform, the surety may prosecute a civil action against the principal in the event the surety becomes obligated to pay a portion or the entire penal sum of the bond. Most GAI's provide the surety with measures to protect itself from a decaying situation. Three basic rights are contained within the GAI:

1. Collateral Security;

2. Inspection of the Principal and Indemnitor's financial books and records; and

3. Settlement of claims without the approval of the principal.

Insolvency has become an all too common consequence of the economy as contractors often default due to poor financial conditions. Thus, sureties pursue rights to the GAI more frequently. If the surety underwriter has an adverse selection book of business, the likelihood is the surety will find

itself in hazardous financial condition because it has not been able to recoup losses from the personal GAI. This is what has happened to two sureties fairly recently:

1. First Sealord Surety, Inc., a Pennsylvania domiciled surety; and

2. Centennial Insurance Company, domiciled in New York.

Recognizing that other business of insurance factors may have played a role in the ultimate financial condition of both companies, be that as it may, each were ordered into liquidation by the respective insurance departments. When that unfortunate event happens, a liquidator is appointed to manage the runoff of the insolvent estate. Further complicating the issue is that some states do not recognize surety as a line of business eligible for guaranty fund protection. Looking back at the types and nature of bonds described earlier in this Alert, one can see that if the surety is declared insolvent, further complicated by a jurisdiction which does not permit a guaranty fund claim, then obligees, project owners and even the principal, are adversely affected and subject to risk.

Upon that occurrence, legal intervention to investigate whether or not the surety has reinsurance may prove prudent. Reinsurance, by way of treaty or agreement, is when an insurance company including a surety, transfers risk to another insurance company called a "reinsurer." Therefore, a reinsurer, in consideration of a premium paid by the surety in this example, agrees to indemnify the reinsured for part or all of the liability assumed by the ceding company. The legal focus will concentrate upon a careful investigation of the treaty provisions in the reinsurance contract specifically looking for a "cut through" endorsement. This endorsement is a provision in the reinsurance contract that sets forth how the reinsurer will pay any loss covered by the reinsurance contract directly to the insured when the surety is insolvent. This provision is sometimes called an "Assumption Endorsement" and may also contain drop down properties. However, not all state court decisions uniformly agree upon the propriety of drop down principles.

In conclusion, the lawyer and law firm experienced in undertaking construction law and surety law matters can perform the requisite due diligence and risk management to evaluate a reinsurance agreement to determine if any of the parties may seek direct relief from the reinsurer when a surety is declared insolvent.

For more information, please contact Carl Anthony Maio at 215.918.3616 or camaio@foxrothschild.com or any member of Fox Rothschild's Construction Law practice.

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