Scribbles Squibs #21 – September 12, 2013 – Dealing With Your Surety As To Claims Against Your Bonds

by Attorney Jonathan Sauer

I. INTRODUCTION:

After having looked at contracts for several *Squibs,* we'll look at some surety bond issues for this *Squib.* The remaining *Squibs* on contracts upcoming!

A. Before the storm: you probably need a surety line (ability to provide payment and performance bonds) if you want to grow and/or perform public work. For new and growing contractors, obtaining a bonding line may be the next step in your development. Possibly, you have been in business for a number of years without a surety line, not really needing it. You have been, for a time, a home improvement contractor, which is the way many subcontractors and general contractors get started in business. The problems with such work, however, can be more complicated dealing with a less sophisticated owner (homeowner), who, quite often, has never been involved with a construction project prior to this one. You have been, for a while, comfortable with your level of success. Still, you realized at some point that you wouldn't achieve the income goals you hoped for when you went into business without growing your business, both in terms of performing higher dollar limit jobs and having a gross dollar volume growth per year. You look at various commercial opportunities and the tremendous opportunities available for subcontractors and general contractors performing public work.

At some point in time, particularly for those in the mechanical trades and those who are potential 'filed subbidders' or 'trade contractors', you have to have a bonding line. In other words, your contracting party or contractee (the one with whom you enter into a contract) won't give you the job you want you unless you have a surety line and can provide payment and performance bonds. For private jobs, many owners get 'poor man's payment and performance bonds' by bonding the major, mechanical subcontractors who have by a percentage the greater volume of any particular job and, generally, the more complicated construction activities. In other words, this is a 'poor man's substitute' for bonding the general contractor. An owner will think that if the major mechanicals are bonded - this is where he has the greatest exposure for problems – at least the more costly aspects of construction have been secured. That, bonding the major mechanicals will give him a sufficient level of protection, even without bonding the general contractor because the performance bond is something approaching a guarantee that the job will get finished and the payment bond is some guarantee that the material suppliers and subcontractors to the mechanical contractors will get paid and, therefore, not lien the job.

'Filed subbidders' in Massachusetts are essentially required to have a surety line. If general contractor bidders carry you as a filed subbidder and decide you are to furnish them a payment and performance bond - their call alone - your inability to do so might cost you some jobs. And, since the purpose of a bid bond or other bid security is to provide some security that

you will both enter into a contract and provide payment and performance bonds, an inability to do so can cause you to forfeit your bid security, whether cash or otherwise.

'Trade contractors' – used in the 'contractor at risk' program commenced in 2004 - are required to provide payment and performance bonds as part of their contractual and legal obligations. I am seeing increasingly the use of the 'contractor at risk' model.

Growth, then, for many subcontractors and general contractors along with having a better ability to get into public construction requires a surety line.

At Sauer & Sauer, we are often asked for referrals to insurance agents who write surety bonds. We know of many good insurance agents doing this throughout Massachusetts. Many are simply well-known throughout the industry and others we meet in dealing with our contractor clients' problems on bonded jobs. We could be one source for identifying agents to work with you in establishing a surety line if you don't know who to go to and we would welcome your calls for those referrals.

B. Trouble raises its ugly head on one of your bonded jobs. At some point, however, your company may go into the claims process, as claims are being made against your payment and/or performance bonds. This is sometimes referenced as being 'in claim'. Having represented at least two dozen sureties with regard to *defending against* such bond claims in a half dozen states, as well as representing numerous material suppliers, subcontractors and general contractors in making claims *against* surety bonds, what follows are several suggestions as to things to do and not to do when you are in claim.

But, first, let's explore for a moment what actions and inactions cause a contractor or subcontractor to fail. And, what actions and inactions make claims against one's bonds more likely? Success with understanding and avoiding such actions and inactions might assist one in staying in business and out of claim.

II. PROBLEM:

Your business has been tooling along. Sure, reduced volume and income for the last several years like mostly everyone else but things are reasonably okay. Money is very tight, however, and your receivables and payables are higher than you are used to dealing with. So, what else is new? For several of your jobs, you are bonded.

Then, something happens. Maybe you got a workmen's compensation retro audit for the last several years and the insurance company claims that you mischaracterized some employees as office employees when they were field employees. The insurance company wants a pile of money for unpaid reasons. Or, you book the wrong job with the wrong contractor or owner. Or, one or more things identified in the next section of this *Squib* happens. For whatever reason, the job goes south.

The following are some of the more common reasons contractors fail and/or go into claim, most of which I have seen in my career as a surety lawyer and as a contractor lawyer. These actions and inactions are not limited to bonded contractors. They can happen to *any* contractor.

A. The reasons contractors fail. There are any number of other reasons companies fail and/or go into claim. I'll list some of the more common things for you to keep an eye on to avoid or to try to avoid or to at least be aware of. They aren't in any particular order of importance. They apply generally: not just to bonded contractors. Also, I am not discussing 'business practice' issues, such as working without written contracts or performing change order work without change orders.

1. One of them is that they ***grew too fast!*** What made them successful at a smaller dollar volume doesn't make them successful today because they have grown to the point where they have exceeded their working capital and administrative framework and abilities. They now have some supers and PM's who are nowhere near as good as those they had when the company was smaller. The additional mechanics they have to hire may not be as good or as productive as the ones they had when they were smaller. Many union contractors I know hate to 'hire from the hall'.

2. Certainly, ***a bad job*** or a ***bad customer*** is a cause for a lot of business failure. Particularly, one has to be careful when one signs a job with someone they don't know. A site guy I had as a client worked sometimes as a general contractor and sometimes as a subcontractor. But, he did one job with this ***new-to-him general contractor*** and things seemed to be going well. He was getting paid on time. Towards the end of the job, the general invited him to price four other jobs, which he did and which he signed contracts for. At that point, the 'dating manners' were suddenly over and there were all kinds of problems, including non-payment, all of which put him out of business and put him in claim. And, this, a contractor who had previously done about ten million dollars per year.

A tip? Go slowly in those situations. Putting a lot of eggs in the same basket too quickly probably isn't wise. Baskets have this way of breaking! For that matter, so do eggs!

3. ***Having more than one business in different locations*** can be problematic. One can't be in two places at once and one will likely never be able to hire someone with your ability and with your commitment to your business.

4. ***Mid-life crises*** are another significant cause. When the head guy starts wearing a lot of gold jewelry, thinks jumping out of airplanes is fun, gets a Harley, gets a girlfriend (which doesn't come with the Harley, although Harley *does* have an extensive accessories catalogue), bad things are likely to follow.

5. ***Drug and other substance abuse*** issues can cause failure.

6. ***Excessive gambling*** can cause business failures. One contractor who hurt a lot of people had three or four casinos listed as creditors in his bankruptcy papers. One year he had a lot of customers come to his beautiful house for a Christmas party. Plying them with liquor and with lobsters, he told them (material suppliers and subcontractors) about his plans for the next year and his desire for more credit so that everyone could make more money. A nice lobster and drinks to go with it along with his silver tongue caused some people to give him more credit, even when he hadn't paid for what had been provided for *prior* jobs. These folks were required, in effect, to pay for their own lobsters! And, ultimately, they did.

Confucius says that you should buy your own damn lobster! When someone else provides it, it may be the most expensive thing you have ever eaten.

7. ***Divorce*** can cause pain on any number of levels, including business failure. (And, one's ex-wife now wants half of the company.) Parenthetically, one of the common *results* of business failure is divorce. Being able to stay in business will help protect your marriage and your family. The stress of going out of business and/or having to suddenly make do with a lot less money and/or being in claim in a serious way is something that some people can't handle, particularly the spouse not active in the business.

8. ***An inability of two partners to resolve business or personal problems*** leading to a split is a cause of failure. Although there are certainly many exceptions, I define 'partner' as someone you are likely going to sue in five years or someone who likely will be suing *you* in five years. It's hard enough to understand oneself. Understanding another is very difficult and, in some regards, an unknowable thing.

9. ***A significant injury or death*** to yourself or to someone close to you is another cause. I know of some people who simply didn't recover from this sufficiently to effectively stay in business. Possibly, they no longer had sufficient energy, whether physical, mental or emotional. In such situations, some people start going through the motions rather than performing as they once did. The military has an expression for this: 'retired while on active duty'.

10. ***One's value system*** changes and one now needs or wants more money than they are used to having.

11. ***Making bad credit decisions*** leads to failure. People, quite often material suppliers, book business thinking what it will do to increasing their gross volume without fully thinking it through. The unspoken premise is that they are going to get paid for all the work they do or for all the materials they ship. When one equates volume with income, there are often a lot of problems. Material suppliers will extend credit to customers who still owe them for the last job(s). I find that business owners themselves extend excessive credit more than their credit departments would and are some of the worst offenders in making credit decisions. Margins being what they are, it's highly unlikely that one can successfully kite jobs. It hasn't worked in the past. Today, it is even less likely to work.

Another tip, particularly for those who use credit applications (such as material suppliers). Often, the credit department will extend fairly minimal credit to a new and unknown customer: say, five thousand or ten thousand dollars. The idea being, 'let's start this guy off slow and see what happens.' But, additional orders come in and everyone seems to forget about the fact that there was an initial limited credit. I am not talking about contractors who over several years paid their bills, thus earning a deserved increase in credit. I am talking of situations where this happens – an unwarranted increase in credit - in the first six months to one year of this contractor's credit performance, often when the contractor's payment history is not good.

For material suppliers, those who don't follow their own credit limits or procedures for a customer may be making bad choices. Those who extend credit without having a decent credit application, perhaps not checking references or not even insisting upon references, may be making bad choices. Those who extend credit without having personal guarantors may be making bad choices. Those who don't have signatures notarized on credit applications may be making bad choices. And, those material suppliers who don't provide for the maximum legal interest payable in the state the work is being performed in may be making bad choices. Those whose credit applications don't specifically provide for attorneys' fees and costs for collection *are* making bad choices. (By the way, a model form of credit application is available at our website, www.sauerconstructionlaw.com.)

Having represented a large number of material suppliers, I have often found that when I receive a copy of the credit application for the purposes of chasing money, the credit application may be only half filled-out and that it is missing required signatures or the signatures are not readable. I have also seen situations where the credit application specifically states that the party applying for credit guarantees the credit personally and corporately. But, just below the signature, the party types in that the credit is *not* guaranteed personally. For whatever reasons, the credit departments seem to often accept these deficiencies.

Benjamin Franklin - a printer, not a contractor, but a pretty smart guy notwithstanding - once said that 'an ounce of prevention is worth a pound of cure'. This was true when he said this and it is just as true today.

12. Now, I'm going to add one that may make some folks uncomfortable. ***Understand the contractual and legal aspects of performing your work and getting paid.*** I find that a surprisingly high percentage of construction folk I speak with only have a general – but, often, incomplete – idea as to the contractual and legal aspects of their businesses and projects. I include in this mix some contractors with a high volume and who are viewed as being very successful.

Now, one way or another, most people end up learning some of these things *sooner or later*. The only problem is that court is not the appropriate place to go to school. The 'tuition' can be quite high. And, by that time, learning these lessons may not be useful with regard to the problem at hand.

Reading things such as this *Squib* and articles contained on websites and attending seminars are really good ideas. Being excellent at the technical aspects of your trade but not as to some of the contractual and legal issues is not enough. An ounce of prevention? A pound of cure? (They tell me that this Franklin fellow did pretty well for himself!)

The list of problems leading to failure goes on and on. Certainly, those who can stay away from some or all of these causes have a much better chance of succeeding (staying) in business. After all, construction is one of the easiest businesses to get into. But, a lot of people doing so are not at all prepared for the issues and things that they will have to deal with.

In preparing this *Squib,* I found on the internet someone who claims that five years after starting a construction business, only 36.4% are still in business. So, approximately only one-third of contractors are still in business five years after they start. (Although scant comfort, there are some statistics which say that 90% of all restaurants fail in the *first* year.) Those who want to stay in business will have to work at it each and every day. *Hard* and *smart.*

B. Going into claim. Here's the deal as to a job for which you are bonded. Unfortunately, you start having a lot of problems keeping up with the schedule. You fall way behind. Your customer is threatening liquidated damages. Or, some of the work is sub-par and has to be removed and repeated. Or, you are not paying your labor and material suppliers and subcontractors (Subcontractors) within whatever your contractual payment cycle is. Your customer is threatening termination with a call on your performance bond. Your Subcontractors are threatening to go after your payment bond. For whatever reason(s), you know that you will not be able to solve these problems with your current resources. And, that these claims *will* be made.

What do *you* do with regards to your bonding company? What do you tell them? What *don't* you tell them? At what point in these difficulties do you go to them?

III. DEALING WITH YOUR SURETY AS TO CLAIMS AGAINST YOUR BONDS:

As to any of these suggestions, I make no comments about ethics or morality as to those who do or don't do any of the following things. That's a personal matter for each person to decide for themselves. Something one might not have done during good times may look different during hard times, especially when there is a threat to your family's financial and other security. For the purposes of this *Squib,* I see my role as a teacher and writer to point out to my students and readers what things are or are not *possible* with regard to their problems. Not to pass judgment.

Contractors are sometimes embarrassed to see a construction lawyer, thinking 'this guy is going to think that I am dumb.' You would go to a doctor if you felt ill, right? You would go to a dentist if your teeth hurt, right? A good construction lawyer simply wants to see whether or not he or she can help you with your problem *right now,* not to worry about how that problem arose before today. None of God's children is perfect.

As to strategies I have seen or I have used or I have heard about that have some demonstrated success once one is in claim. Here are some ideas, not necessarily in any order of importance:

1. Be proactive. Don't go turtle. When you know what hits the fan, some people may tend to hide for a bit. They are hoping the problems somehow will go away. They may not feel up to dealing with them. All of this is understandable. When presented with a 'fight or flight' situation, some folks fight. Other people flee. But, it *is* the early bird that catches the worm in so many situations. Not being proactive with many of the strategies discussed elsewhere in this *Squib* may lead to less satisfactory results. Events may overtake you without your having an opportunity to have participated in deciding those events. People who hide from their sureties generally are not going to like the results. So, as hard as it may be, as tired as you might be, as *scared* and *heart-broken* as you might be, be proactive. Example: I hear from some that a lot of folks today are depressed. For one large failed contractor in particular, this was exactly the problem. Some say there are medicines that are fairly effective – and, relatively quickly – in dealing with symptoms. This could be a proactive example likely to save some people money in the long run and, hopefully, shorten the particular claims process which for some could be a nightmare.

Here's a hard lesson to learn. One of the most common mistakes I see failing contractors make is to not recognize the inevitable. One thinks: 'if I *just* work even harder today', *somehow*, I can turn this around.' The owner of the company starts putting substantial personal assets into the business, often a futile strategy and a very big mistake.

I have read that in the various twelve step programs there is this saying: 'The only time that you are going to be perfect is when you are perfectly dead.' Not recognizing that your business *is* dead, a common mistake many make, can be a very costly mistake, particularly when you have guaranteed a credit line and/or a bonding line and you will need money to deal with. The same personal assets that might have responded to such claims may have been wasted by pumping them into a business that is not succeeding and will not succeed, the effect of which expenditure may only be to delay the inevitable. Those same personal assets, at minimum, are usually necessary to finance one's personal and family life during this transition from a failed/failing business to the next business. Groucho Marx once said: "Paying alimony is like feeding hay to a dead horse." Not recognizing that one's business is already dead while investing further personal monies into it is as equally futile.

2. It is wise to make the following seemingly unhappy assumption as early as possible in your business life in construction. That is, in all likelihood, at some point in time, your company will close its doors or fail, for one reason or another. Maybe for one or more of the reasons listed elsewhere in this *Squib*. There are few exceptions. (Who ever thought that Modern Continental would file bankruptcy in 2008, its being for a time, one of the largest general contractors in this country?) Eastern, Peabody Construction, R.W. Granger and any number of other former players in Massachusetts are no longer with us (at least in those forms).

It is very important for you to remember that if you do business as a corporation or as an LLC, legally, you and the corporation or LLC are separate and distinct legal entities with very few exceptions. The corporation is not you! The limited liability company is not you! The corporation's failure doesn't mean that you are necessarily a failure! But, what if the company *did* fail by something you did or didn't do? No one is perfect. Except for those who are perfectly dead. And, at least yet, that doesn't apply to *you.*

According to the internet, Walt Disney (before he *was* Walt Disney*)* had to file personal bankruptcy himself once. According to the internet, Donald Trump has been associated with four business bankruptcies. A result is that he got his own television show.

Few construction company owners ever *really* die (leave the industry.) People who have worked in the construction industry before their business failed will, in all likelihood, do so after the failure. Try to think of your corporation or LLC as a nice suit. Sure, it fits well now. It looks pretty good. You are proud of it. But, at some point in time, you will need to replace it with a new one. Maybe it is showing wear. Possibly, a little torn. Maybe even out of style.

Whatever the cause of the failure you suffer, whether attributable to you or to others, learn the lessons it has to teach you and try *again*. Hopefully, next time you will do *better* because of the lessons you learned from this failure. Thomas Edison reportedly had ten thousand different attempts to make a light bulb until he actually figured it out. Ten thousand failures? He is one of the most famous people in modern American business. And, truly, a great man.

3. Hopefully, you have prepared somewhat for this day. Hopefully, you have a homestead on your house. (In Massachusetts. this provides usually five hundred thousand dollars' worth of credit protection for your home against your creditors.) Possibly, some of your property is in a non-indemnitor's name - they didn't sign the general indemnity agreement (GIA) as personal indemnitors. Possibly, you have formed various trusts with a really good wills and estates lawyer – the trusts will stand up to and survive litigation - in which you are not a named beneficiary. Possibly, some of your wealth is in things other than cash or real estate, in things such as gold, silver or precious stones.

It would be *better* to make such plans in advance of your signing the GIA. This is the agreement in which you agree that you will reimburse the surety for all losses and expenses it incurs, completely irrespective of whether you are wrong or not. And, let's be clear. Your indemnity obligation is there whether you are ultimately proved to be wrong or not. In 'suretyspeak', a 'loss' payment is one a surety makes to a claimant to resolve a claim. An 'expense' payment is a payment to a consultant that the surety makes to assist it in handling claims, such as to attorneys, accountants, completion services, private investigators, etc. For our purposes for this *Squib*, we'll refer to both loss payments and/or expense payments as 'Losses'.

Making these arrangements before you sign the GIA will diminish somewhat the surety's chances of success in trying to undo some of these transfers down the road, claiming that you made 'fraudulent conveyances' (the transfer of property to someone for little or no value *after*

you have incurred a legal obligation.) Some states see the signing of a GIA as creating a 'legal obligation' even where the GIA is a contingency agreement to deal with Losses and no Losses have been incurred yet.

Generally, both husbands and wives owning stock in a prospective bond principal above a certain percentage will be required to sign a GIA. And, spouses, your getting a divorce does not affect your indemnity obligations to the surety with regard to a GIA you signed before the divorce. After all, a GIA is a contract and by your signing this contract, you, yourself, have assumed obligations under this contract. In a legal context, a court will enforce the obligations you assumed by contract with no consideration as to the fact that you signed the GIA when you were a spouse and you are no longer a spouse. A spouse's potential liability to a surety for Losses might be something to consider when negotiating a divorce settlement agreement, possibly providing that the other spouse indemnify you against surety claims made against the spouse. Also, please keep in mind that most GIA have a specific provision indicating how one gets off of the GIA as to future bonds. While that won't protect you as to outstanding bonds, at least you can eliminate exposure as to subsequent future bonds.

Once you go to an insurance agent specializing in bonds, it's a given that the principal (your company) and a number of individuals will have to sign the GIA. You simply will not get surety bonds without first signing a GIA personally. So, whatever asset protection strategies you might employ, these should be decided – or, at least, looked into - before that first visit to the insurance agent's office.

A common requirement for especially first time surety bond purchasers is for there to be some type of financial statements for the company, possibly even for the individual owners, particularly where the construction company is new. There are three types of such statements: audits (the most comprehensive and expensive), compilations and reviews. For first timers, you will probably need audited statements. Identifying the CPA you will use for this before you first visit the insurance agent is another good idea, both for your budgeting purposes and to understand up front when the CPA will be able to do this work. For, once you meet with that surety bond agent, you probably will be quickly signing all kinds of paperwork preparatory to getting your first bond. After all, in most cases, someone will be looking for a surety line because they have an interest in a current job that they are bidding or want to bid which requires one. Much as the Boy Scouts' motto is to 'be prepared', there will be certain steps you will have to take to get that first bond. Financial statements will be one of them.

4. If it is clear that your business will become insolvent or fail in some other way, in the months leading up to closing it down, focus most of your money and energies on completing bonded jobs and in paying your Subcontractors on bonded jobs. If you file bankruptcy personally, trade creditors will generally not be able to make claim against you personally for trade debt (unless you personally guaranteed your company's credit.) After all, that is why you do business as a corporation or as an LLC.

This doesn't apply to the surety, however, where you have personally guaranteed the debt in the GIA. Since the surety and – in all likelihood – the bank providing your credit line *can*

come against you personally in bankruptcy, they should be taken care of first *before* you go into bankruptcy. And, since performance bond claims are generally more expensive than payment bond claims, if you have to choose where to put your time and monies, work at completing the bonded jobs first rather than paying off companies having rights against your payment bond. At some level, your surety will appreciate this effort. And, it is likely to save you money as an indemnitor.

5. Unless you file bankruptcy personally, you are probably not going to be able to legally avoid your indemnity obligations. Indemnitors like to flee to Florida or to California, thinking that distance offers some protection. It might have offered *some* protection in the pre-internet days but affords little or no protection today. Today, if a gopher farts in the middle of the Sahara Desert, the whole world knows about it within an hour (whether it is interested in this kind of thing or not.) Any number of pieces of personal information about you, including your social security number, place of birth and date of birth, will enable the surety to find you, most of the time, fairly quickly. And, even if they don't have this information as to you, it is possible that they might have this as to your spouse. If they can find your spouse, they can find you.

Some GIA call for such information. The fact that I have seen many GIA which call for it but do not have it suggests that the surety underwriters sometimes will let your application go through without insisting on this, possibly due to market and competitive pressures, otherwise good supporting documents (the audits), and, because they are not one hundred percent sure that they are entitled to even *ask* for this information. (It is my understanding that within an employment context, the employer cannot ask a prospective employee their age or, as to women, whether they are intending on having children or not.) Other than not insisting on this information for the reasons above, folks make mistakes. After all, the sureties want to earn the bond premium.

Another tip. As to legal documents people wish for you to sign, the fact that information is called for doesn't necessarily mean you have to provide it. Various provisions of typical construction contracts – a term saying, for example, that a subcontractor agrees not to file mechanics' liens – are unenforceable (in Massachusetts.)

6. Do not lie to your surety, especially when they will be able to prove this through a witness or through your own (or the claimant's) documents. Having a good moral character, believe it or not, is something that the surety traditionally looks for in determining whether or not to do business with you (write bonds for your company) in the first place. That's one of the Travelers Insurance Company's famous 'four C's'. Namely, for a contractor to obtain bonds, the contractor has to demonstrate capital, capacity, competence and character. My own experience has demonstrated time and time again that once one is in the claims process, 'character' may be the only one of these things still there. Once you have lost the surety's trust in the claims process, you won't be able to do some of the things mentioned in this article and you'll have a bigger indemnity bill if there are Losses.

An exception to this is that you might not want to be too forthcoming with information as to your personal assets. It may be wise to withhold this information and documents as long as

possible, particularly if the assets picture is likely to change. In civil litigation (in Massachusetts) a plaintiff has a very limited right to ask a defendant as to that defendant's assets before a judgment is entered. Within the surety context, while the bond claims examiner is attempting to handle your payment and performance bond claims, however information as to your assets might be desirable, the bond claims examiners are likely to be spending most of their energies and time in claims management.

7. Let the surety hear about a potential claim problem from you as to any claim that is likely to go to the surety *before* they hear about it from someone else, such as the claimant. This might be the most important thing I have said in this *Squib*. The surety has your legal and factual defenses as a matter of law and as a matter of contract as their defenses to any claim. Meaning, they are very interested in knowing what your factual and legal defenses might be as to any particular claim. It will surprise no one for me to say that a bond principal communicating with their surety is likely to emphasize the facts that are more favorable to them and ignore or minimize those facts that work against them. Notwithstanding, being first will usually work in your favor!

So, sending them a detailed, documented history and explanation of the problem on a performance bond claim, for example (even when oriented somewhat more favorably to your position than the facts might warrant), might keep the claims representative from settling claims too quickly or against your wishes. The surety does not generally need your permission to incur Losses, whether as to expenses or as to paying claimants. They can do so even directly against your expressed wishes. Be sure to document your position with such records as you have.

Try to make this presentation to the surety only *once*. In other words, give them the information and documents you think that they will need to understand your problem and to understand your position with regard to that problem. Here's a way to ensure that your presentation is successful. Give a copy of your intended claims presentation to someone not familiar with the issue and then ask them whether they understand what you are trying to say or not. By my experience, many subcontractors and general contractors are not good letter writers. Try to involve in your presentation someone who is a good letter writer. A chain is only as strong as its weakest link. If the bond claims representative does not understand what you are saying or trying to say, this probably won't be helpful with regard to your claims situation.

As to payment bond claims, you will want to point out to the surety any defects in the Subcontractor's performance, materials and timeliness of performance, including any resulting additional costs you incurred directly or which were incurred by your subcontractors. Pointing out errors in the claim numbers is important. In my seminars for claimants as to how to present a payment bond claim to the surety, I urge them to get 'third party verification' letters as to the sufficiency of their performance from people such as the owner, the architect or the clerk of the works. It is equally important for someone resisting or defending against a surety claim to have such a letter(s) pointing out the negative aspects of the claimant's performance, whatever such might be. (If you need a form for a 'third party verification' letter, email us and we will send you one without charge.)

8. Try to find someone to finish your bonded job or otherwise give the surety some ideas or a plan of how your work might be completed as quickly as possible and as cheaply as possible. Bond claims representatives will often have no real idea as to how to accomplish this result. Also, when the surety is considering completion contractors, (people to finish and correct your work), keep in mind that they can tender *you* as a completion contractor to your obligee (the party to whom the bond runs, similar to a beneficiary.)

I see this using of the bond principal (your company) to complete the work as a frequent occurrence. The surety will also consider those who originally bid the job as potential completion contractors. Sometimes the surety will take bids from subcontractors or general contractors typically performing your trade. They will often do this limiting the pool of bidders to their current bond principal customers, which may not work to your advantage. Giving names of potential completion contractors to the surety can be helpful to both of you. Helping the surety figure out the cheapest way to complete your work is likely to keep the Losses down. As an indemnitor, this is something of critical importance.

These are some of the common options the surety has with regard to a performance bond claim: (1) do nothing, for whatever reason. This may be because they agree with your documented position *or* find that a determination of who is right – you (the principal on the bond) or the obligee (your customer, to whom your bond runs) - is too hard to make at this stage *or* because the claimant has made a procedural or substantive error in the presenting of the claim; (2) settle the claim with a cash payment of some kind (the obligee might take this as they are willing to consider folding the remaining work into some project they are likely to have in the future, this particularly with regard to public jobs); (3) finish the job using a completion contractor, paying the difference between the amount of contract funds available and what that contractor's price is; (4) finish the job by tendering *you* to the obligee (the party holding the bond) as a completion contractor; (5) take bids, either jointly with the obligee or by themselves (depends on the performance bond form), to get potential completion contractors; (6) complete the job itself using the existing subcontractors and a principal's former employees or a construction services guy; (7) pay the penal sum of the bond – the whole amount of the bond - when the surety thinks that the contract cannot be finished for the amount of the performance bond.

Since you now know what the surety's options are, try to convince the surety towards using the method most likely to incur the least amount of Losses.

Sureties often claim that they have the right to tender your company as a completion contractor. In other words, as a subcontractor, you are no longer working contractually for the general contractor. You are now working directly for the surety. I've had many situations where the obligee has accepted this, particularly when they have no real problems with your work but just do not like you or your PM. They might say: "That's ok. You guys deal with him (the contractor). I'm sick of doing so."

9. With bonding company approval, acquiescence, plausible deniability or lack of knowledge, settle some of the payment bond claims yourself. Here's one way I've heard it done. One tells the Subcontractors a variation of the following as a 'pitch' to the trade creditors:

> "My business is closing its doors. The owner (or the general) has put me out of business. The bonding company is going to take over my business and jobs. In all likelihood, we're going be filing bankruptcy shortly. Look, you're a good guy. *I'm* a good guy. We sure did a lot of business together in better years! We both made some money! I suppose you can go to the bonding company and wait five or six years for them to pay you. Up until then, the only guy making any money will be your lawyer. Or, maybe I could get you paid out of some money I might be able to borrow from some people I am speaking with. Right now, I'm trying to work out some deals with my best Subcontractors, the guys I like and the guys who have worked with me through the years. I could probably get you about (one-half/two-thirds/three-quarters or whatever works) of your money in a few weeks for a release of my company and the surety. Down the road, with the new company I am thinking of forming, we can do some more business together and make some money. Just like we did before. Does this make any sense to you?"

If it does, then ask for a bonding company check and have the Subcontractor sign a standard surety release and assignment. The surety couldn't engage in such a practice in Massachusetts itself. That would probably be an unfair insurance claims settlement practice, which could mean multiple damages and other bad things which might happen. Doing this yourself might be, technically, an unfair and deceptive trade practice. But, if your company is broke, one can't get blood from a stone. And, if *you* do it and are successful, you can help keep the indemnity bill for the Losses down.

Obviously, to those material suppliers and subcontractors having such claims, be aware of this type of approach. Depending on who you are and who they are and the past nature of your relationship, this type of approach might make sense to you. But, many think that giving a surety a discount on their claim is a bad idea. As most cases settle well before trial, the surety's concern over possibly having to pay interest on your claim and potential attorneys' fees with regard to your claim (Massachusetts' public jobs) will cause the more effective sureties to settle clean claims sooner rather than later. Yes, you will wait some. But, particularly when you have effective legal assistance, you will not wait forever.

10. Help the surety in settling payment bond claims. This would be a more straight-forward approach than that suggested above. Maybe the last method didn't work. Maybe your surety wouldn't go along with it. Maybe the claimant – or his attorney – knows that there is no reason ever to give a surety a discount on a payment bond claim if the money is owed. So, settle the claim in accordance with what the contract requires and what the numbers indicate. Your surety might want to do this in this way. It might be better – *cheaper* – if *you* did this rather than having the bond claims representative do this. The claimant knows you. He might even like you. In a time of poor economics when a lot of contractors have failed or are failing, *some* money in hand is appealing.

11. Settle as many claims *as claims* as you can rather than letting them go into lawsuits. Once lawyers get involved, you'll have to deal with legal fees (your's, your surety's and, possibly, the claimant's) and more likely will have to deal with paying interest. In Massachusetts, if there is a suit, a successful claimant on a contract claim generally gets twelve percent interest per year or higher (depending on things such as your having a credit application or contractual provision with a higher percentage rate, for example.) On larger payment bond claims, these additional items can *really* add up. If you can settle the claim with the claimant directly, there might not be any attorney involved. And, not all claimants know about what the interest situation is. My experience is that they are often happy to get paid *something* without a suit, interest itself not being an issue.

12. Be available to the surety. Answer promptly their phone calls, their letters and their requests for information and documents. Go to meetings with the surety and your claimants. (Usually, but not always, this would be with regard to a performance bond claim or larger payment bond claims.) If the bond claims representative starts seeing you as more than a defaulting principal - as a good guy, *a person,* maybe even as a kind of friend - the indemnity process might work more to your liking. I know of some situations where a surety would even pay a consultant's hourly rate to a key indemnitor (former company big wig) with a lot of information, who could help with the completion of the jobs, the evaluation of payment bond claimants or both. Personally, I have hired (and paid 'weekly salaries') to any number of former head guys from failing principals and used them as supers to finish the job using whatever remains of the principal, existing subcontractors and others. This often is the cheapest way to get the job done and, even more so, is the *fastest* way to get the job done. And, maybe this might be a source of income for you, particularly helpful during this dark time.

13. Sureties are far more interested in directing their attention to performance bond claims first, rather than to payment bond claims. With performance bond claims, the surety is more likely to incur the highest Losses. Claims by obligees that the surety acted in bad faith are far more serious (and likely) with performance bond claims than they are with payment bond claims. Quite often, the obligee is demanding liquidated damages or other delay damages in addition to a claim for performance. And, the surety is trying to get the contract funds held by the obligee to be used to help finance completion and/or to reimburse itself for the payment bond claims it has to pay. Sureties are more likely to especially appreciate your assistance in resolving performance bond claims, something that is not likely to hurt you when it's time for the surety to consider what to do about the indemnity bill for Losses.

14. Sureties will almost never loan you money to finish your job. (I have had some situations where sureties did this indirectly because having you finish the job is the fastest and cheapest method. You will never see any of the money yourself, however.) But, it is a fairly common thing for sureties to give you 'back door financing'. This means that they allow you to finish the job yourself, knowing that they will be receiving future payment bond claims from the Subcontractors with both historical claims and from those who are helping you to complete. This type of thing can happen pre-claim or post-claim, as provided for in the takeover agreement and completion contract. A lot of experience suggests that your completing jobs in this manner

prior to the obligee's making a performance bond claim will likely save both the surety and you a lot of money.

A surety is more likely to go along with having you complete the job: (a) where the job is close to being done; (b) where the principal is the only one able to provide a certain material (because it is an exclusive dealer) or process (it owns the patent or other intellectual property rights for what is necessary to complete the job); (c) to hopefully avoid paying liquidated or other delay or consequential damages inasmuch as you are likely the option most likely to get the job completed most quickly; (d) where the surety thinks that by doing so, this situation can be resolved without your going into claim, where they are likely to pay more; and (e) where the surety is not getting good prices from potential completion contractors or they can't find potential completion contractors who will even bid the job or be in a position to complete the job right now. Therefore, if your company might fall into one of these categories, one of the plans you might present to the surety at the go-in is for them to simply allow you to finish the job and pay material suppliers and subcontractors through the payment bond, your immediate payroll and other direct costs through a 'job control account' which the surety will set up.

15. When the claims are going to be mostly payment bond suits, consider asking the surety to 'tender its defense' to you, meaning that it should be represented by your lawyer at no charge to the surety. Where the surety's defenses are largely the principal's defenses, there is enough common interest between the surety and the principal so that this might work. Otherwise, if the surety hires its own lawyer, that lawyer's fees will be part of the Losses. Prudent sureties may inquire as to your lawyer's construction law background and experience before they will agree to this. So, one of the factors to inquire about when engaging a construction lawyer is what their experience is in representing sureties under a tender of defense. You are going to have to pay your own lawyer anyway. Since you are likely obligated to reimburse the surety if it itself has to hire a lawyer, why pay for the same thing twice?

16. Sureties are more likely to push for indemnity – or push harder – when the Losses are larger. Ten years or so ago, one bond claims representative told me that his surety – not a particularly large one – considered indemnity claims under one hundred thousand dollars to be 'small claims'. This is not to say that such sureties won't be looking for indemnity at some point. But, I think that your better chance of getting 'a deal' is with such smaller Losses, particularly where you have used some of the strategies discussed in this *Squib.*

17. Here is one for you to hear loud and clear. Do not assume that you will be able to beat the surety in its indemnity lawsuit against you. The only real defense for an indemnitor in Massachusetts to an indemnity case is if the indemnitor can prove that he/she didn't sign the indemnity agreement. (It happens, but rarely). Sureties win the vast majority of indemnity suits, many of them at the 'summary judgment' stage of the case before and without a trial. There is a Massachusetts case saying that an indemnitor's claim that the surety acted in bad faith towards the principal or its indemnitors isn't even *relevant* in an indemnity matter. In the majority of cases, before the Losses are incurred, assume that you will lose the indemnity case and make your plans accordingly.

An exception to prove the rule, I know of one situation down south where a surety not only didn't recover indemnity in its claims against the indemnitors/principal for significant Losses incurred in finishing a school but ended up paying a million dollars to the principal, by way of settlement, for claims that the principal had against the surety for bad faith! *Such a result is <u>extremely</u> rare, not likely to happen in Massachusetts.* Readers, please be aware of the fact that each state's statutes and court decisions first and foremost apply to and control such matters occurring in that state. More simply put, each state's laws are or may be different.

Such a result is not likely in Massachusetts because of our case law with regard to indemnity claims. In that case down south, there were some unusual facts and some very unusual characters associated with it. While I would not usually choose to tussle with a surety representing indemnitors in an indemnity action, under very rare circumstances, an indemnitor might have a 'puncher's chance'. That being something said about George Foreman when he re-entered the boxing world quite a bit older and heavier than he was when he first was successful. Meaning, that even though his age and physical conditioning would probably not allow him to even *finish* a twelve round fight, he might get one good punch in that would end the match. A 'puncher's chance'.

18. At some point in time, consider making a plan for repayment to present to the surety even before the surety itself has raised the issue. Many of the ones I have done or seen would have the pay-out to the surety be over a period of years with a modest interest rate. My experience is that few sureties really want to push claims for indemnity, unless their Losses are large and/or they believe some of the indemnitors have money. They don't want to incur the legal costs of doing so and they know that they will be generally unable to get indemnity anywhere near one hundred cents on the dollar in the majority of cases. Making and presenting a plan to the surety before the surety has presented you with its own plan helps preserve your property, avoid legal fees in participating in an indemnity lawsuit that you are likely to lose in any event and gives you a way to plan the resolution of this problem in a way that's best for you.

Here's a tip. Indemnity obligations are usually 'joint and several'. That means that all of the indemnitors owe the Losses to the surety in full as a group and any one indemnitor owes the surety for all of the Losses himself/herself. Try to get the surety to accept from you only your proportionate share of the indemnity obligation. So, if there are six personal indemnitors, try to get them to accept from you only one-sixth of the Losses. If the six people are three married couples, then you would be looking to try to pay back only one-third of the Losses. Frankly, I haven't had much success with this. I would think your chances might improve when you have been a useful, helpful indemnitor, doing some of the things for the surety's benefit related elsewhere in this *Squib*. They say that what goes around comes around. I have seen this happen in some indemnity situations.

19. Don't be afraid to attempt to negotiate your indemnity obligation. Other than threatening personal bankruptcy and then doing it, you usually wouldn't have much leverage in negotiations with the surety. But, it can hardly hurt to ask for something you would like but are not legally or contractually entitled to. Nothing ventured, nothing gained!

However, counter-punching and claiming that the surety acted in bad faith towards you almost never works. Also, if you claim that the surety acted in bad faith, what you are really saying is that the bond claims representative handling your matter acted in bad faith. More likely than not, you are just going to piss him or her off. Also, then, 'it's personal' for the bond claims representative and you almost never want to make it that way. You want them to have only a business interest in you as relates to your job and indemnity obligations. Also, by alleging that the surety acted in bad faith towards you, the surety is more likely to make the indemnity suit against you pushed harder. It is likely to be more expensive and will likely hurt you down the road with your negotiating position in attempting to only pay your share of the Losses or all of the Losses for only cents on the dollar.

Only about one percent of all Massachusetts civil cases go through the entire trial process in the superior court. This means that the great majority of cases are settled on some basis before the trial occurs or is completed. Always keeping an eye on the negotiation possibilities just makes sense.

20. Familiarize yourself with what a surety's 'personal' defenses are. Certain bond forms specifically require a claimant to provide notice to one or more people or companies within a certain timeframe before a claim can be made. This is particularly so with payment bond claims. Also, certain specific notices may be required by statute. For example, on second tier claims against a general contractor's payment bond on a Massachusetts public job, a condition precedent to such a suit is that this claimant has to give the general contractor a specific letter certified mail, return receipt requested, identifying itself, who that party's contract was with and what is the amount of the claim before any suit is possible. Such notice must be made within sixty-five days of that party's completing its performance on your job. (This is, generally, ninety days on federal jobs, although not all federal jobs are subject to the 'Miller Act', which contains this requirement.)

Also, suits on general contractor payment bonds in Massachusetts and federally have to be commenced within one year from the last date that party last furnished labor or materials for which claim is made. Make sure that any claims against your payment and performance bonds comply with your bond's or applicable statute's requirements. It could be a mistake to simply assume that a bond claims representative knows the laws of your state. The bond claims representatives may work in many of the fifty states and a great number of them are not lawyers. They often have a heavy workload minimizing the time they can spend on any particular loss. Providing them with this information assists both of you in keeping the legitimate Losses lower.

21. Know what your personal insolvency options are as *early* in the claims process as possible. Preferably, knowing these *before* you start dealing with the surety in any significant way in the claims or indemnity process might be useful. One knowing that he/she will likely be filing personal bankruptcy is in a very different situation from one who is not planning on doing this. A surety in most circumstances in bankruptcy will only be an unsecured creditor, which is at the same level of a trade creditor in a claim against your company. The surety is not likely to recover much, particularly in a Chapter 7. And, the surety *knows* this.

22. Having an attorney familiar with these issues on-board as early in the claims process as possible is likely to help you. If some of the points above are new to you, had you gone into claim before reading this *Squib*, your indemnity bill for Losses might have been larger. In addition, when one is intimately involved in the problem, one often lacks the objectivity necessary to make good judgments.

23. One way or another, you *will*, at some point, get through this process. Tomorrow *is* a new day. And, hopefully, your family is your greatest source of joy and pleasure, which should be there during and after the claims process and protected by you, to the greatest extent possible, through-out this process.

IV. CONCLUSION:

Going 'into claim' is an uncomfortable experience for those having to endure it. I have represented at least two dozen sureties in several states over an extended period of time with regard to defending payment and performance bond claims and lawsuits and in the pursuit of indemnity. My wife, Sally, before she became an attorney, worked for ten years as a bond claims representative on surety claims for a number of companies, including some major companies.

Today, as lawyers, we mostly defend subcontractors and general contractors and their individual indemnitors as to surety claims for indemnity and in making claims against payment and performance bonds for our material supplier and subcontractor clients. We have substantial experience on both sides of the equation and that knowledge as to how each side sees the issues is often very helpful in resolving claims.

Following some of the above suggestions will hopefully make the claims and indemnity processes a bit easier, more understandable and less scary, also achieving some costs savings *for you*. But, this is not likely to happen without your considered approach to these problems, not just letting such problems overtake you while you hope for the best. A wise person once said: 'a failure to plan is a plan to fail'. If your company is or will be failing, a failure to plan for how you *personally* are going to get out of problems with the surety is probably not in your best interests.

(These materials are intended as general information only, not specific legal advice. When confronted with a legal problem you don't understand, seek the assistance of legal counsel. Construction and surety law are things that most 'general' lawyers don't do a lot of. At Sauer & Sauer, we ***only*** *practice construction and surety law and we attempt to assist our clients with surety claims, whether it is defending your payment and performance bonds or going after someone else's payment and performance bonds with affirmative claims. Involvement of a knowledgeable attorney earlier in a problem can often result in a better, cheaper and more favorable outcome.)*

SEVEN QUICK THINGS TO KNOW ABOUT OUR FIRM:

1. No charge to non-clients for quick answers to *general* Massachusetts construction law questions.

2. We guarantee our billing rate for five years in writing for all new clients through the end of this year who mention this offer at engagement.

3. As trials can be expensive, take a great deal of management time and the result of which is uncertain, we make our best efforts towards seeing whether something short of a trial – such as mediation – might be possible for resolving the matter. If a trial is necessary, however, we have a lot of experience trying construction cases.

4. We endeavor to maintain, wherever possible, possible future business relationships with your contracting party you are currently in a dispute with by emphasizing a fair and reasonable approach to the resolution of disputes, which often helps promote earlier (and cheaper) case resolutions than does lawyers who are 'mean and angry'. And, while you might say now that 'I'd never work for that guy again', a lot of experience over several decades suggests to me otherwise! Given the right job, more than likely, he'd be given another chance. Particularly if it is a *good* job!

5. We try to defer until later in the case the more expensive elements of discovery – i.e. depositions – in order to try less expensive discovery first. We recently obtained a 1.5 million dollar settlement for a subcontractor against a bankrupt general contractor's payment bond surety on three projects without a single deposition ever being taken and without our client's even having to answer and sign interrogatories.

6. Being a smaller firm, our attention is focused *solely* on our clients and their problems, not on feeding the overhead of a fancy office and many partners, associates and support staff. We only have to feed our five dogs, most of which, however, are *quite large!* If you ever meet The Worm, be respectful and, perhaps, a bit wary. After all, Rotties *can* be difficult! Especially around meal times. For big dogs like this, it is almost *always* around meal times! Or, close enough so that the difference isn't noticeable.

7. Satellite offices in Boston and Worcester for more convenient meetings.

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