TRAVELERS

Serving as an indemnitor for a contractor who does not independently qualify for surety credit presents significant risks

Providing third party indemnity for a new start-up company, for a friend, or for a smaller disadvantaged business is not a new concept in the surety industry. But over the past two to three years sureties have seen an increase in this type of third party guarantee due to the recent economic recession and the increase in government mandated requirements for minority and service disabled construction companies, which has resulted in less qualified small disadvantaged businesses entering the marketplace. With the increase in activity we have also experienced an increase in claim activity on "good buddy" bonding deals turning very bad and costly for our contractors. Risk is served up in different forms every day, but the risk of thinking that this time will be different, that the risk is not that great, is seductive, particularly if you are asked or are willing to serve as an indemnitor for a Contractor that does not independently qualify for surety credit. Clothed in what appears to be opportunity, this risk has the potential to beggar you, not profit you. Having had the unfortunate opportunity to see many "this time will be different" deals, we want to share our perspective and experiences with you in a handout format that highlights the risks you take as an indemnitor for a Contractor that you do not control. Because this time, we hope, will be different.

Financially distressed/inability to qualify

There is an increased risk of default and failure because the Contractor you are indemnifying for lacks the independent financial wherewithal to fund the completion of the bonded contract and its other backlog given the absence of a financial cushion for unforeseen problems or payment delays. Your indemnity is therefore necessary to address these concerns and is taken with the expectation that you are primarily responsible. As such, do not expect that the surety will pursue the Contractor first and only look to you for any shortfall later.

- There is an increased likelihood of a larger than normal loss relative to the project amount.
- The size of the potential loss may substantially impair your Company's financial stability.

Exposure to problems not directly related to project

Issues outside of your control may put the Contractor into a cash crunch, such as the Contractor's bank sweeping bank accounts, calling the line of credit, or the IRS filing tax levies because of unpaid withholding taxes. Other problems in the Contractor's backlog, outside investments, and other third-party claims, may create a ripple effect that overwhelms the Contractor, leaving you to finish the project(s) and pay the bills.

Indemnitor contractor does not have privity of contract with the owner/obligee

You and your Company will not have a contract with the Owner/Obligee. You will not receive notice of project issues from the Owner and you will likely be excluded from contract changes and negotiations with the Owner. It will be difficult, if not impossible, to affect any contract changes or negotiate with the Owner. While the Contractor may be cooperative with you at the outset, if you later disagree with them over how they are managing a project you guarantee, they will be free to cut you out of the decision making process and make commitments and settlements that you may not have made in their position.

Inability to control project funds

You and your Company typically cannot secure project funds from the Owner. Even if a project agreement is established or a separate escrow account is set up, the Contractor may be able to subvert any pre-established arrangement you have with the Owner to send money directly to the escrow account, if such an arrangement is even allowed by law. This outcome potentially leaves you with no recourse against the Owner, as the Owner may not have any legal responsibility to you. Further, the Contractor may cross-apply or divert funds from the project that you guarantee and either use those funds to pay subcontractors and suppliers on an entirely different project or use that money for overhead or paying its bank. To the extent necessary, you will have to make up any shortfall caused by the diversion.

No control over project execution

You and your Company will not have contractual control over subcontractors or material suppliers. Although you may see a problem developing with a subcontractor, there is absolutely nothing you or your Company can do to affect a change or improve performance because you do not have a contract with the project's subcontractors or suppliers.

Inability to mitigate loss at time of contract default

There is no guarantee that the Owner/Obligee will agree to have your Company, as the indemnitor, complete the project in the event of default. Also, the surety may choose to re-let the project to the lowest bidder as that may be the most cost effective manner to complete the project and pay amounts owed to subcontractors and suppliers. The surety will look to you and your Company to fund this loss.

- Some owners, including the Federal Government and other public owners have the ability to select a contractor of their choosing to complete the project with no input from the surety. In these situations, the cost of completion could be very high, notwithstanding which the indemnitors would have to still fund this cost following the surety's request for them to do so.
- In the event the Contractor is small business / DBE / Service Disabled Veteran qualified, the Owner/Obligee may insist on a similarly qualified firm as the replacement contractor.

Probable expected and maximum loss

Actuarially proven statistics have established that the average probable expected cost of a surety loss is typically 29 percent of the Contractor's aggregate bond limits, which equate to the original contract prices for the projects in the Contractor's backlog at the time of default. For example, a $6,000,000 contract could yield a $1,740,000 loss. The maximum probable loss, on the other hand, is even higher, potentially as much as $4,260,000 or 71 percent of the contract amount. The likelihood of a loss on a Third Party indemnity transaction where the principal Contractor is undercapitalized and does not qualify for a bond is very high, which makes the probability of a loss higher than normal[1].

Examples of third party indemnity gone wrong

- In order to qualify for surety credit, the Contractor needed another company (Company) to indemnify on its behalf. The other Company did so for a fee. Subsequently, 12 bonds were executed over three and a half years totaling $130 million. The Contractor encountered financial difficulties arising from it underbidding a number of the projects and its inability to properly prosecute the work. The Company that provided its indemnity stepped in and worked with the Contractor to complete the projects. In addition, the Company directly completed some projects with its own forces. The initial loss estimate was under $10 million. Over time, the actual loss ballooned to over $45 million, which did not include additional exposure of $25 million. The Company, although a very competent contractor, was unable to stem the losses. The ensuing loss put the Company at risk of failing completely.
- The Company structured a trust/joint control account with a Contractor in order to control the contract funds. The Company did so because the Company was indemnifying a surety on behalf of the Contractor. The Contractor submitted the winning bid. Thereafter, the surety issued the bond in reliance upon the Company's indemnity. The first pay estimate ended up in the hands of the Contractor. It was the largest sum of money the Contractor had ever seen. The Contractor diverted the money and invested it in a get rich quick scheme that failed. The Contractor became unable to complete the project. After a struggle with the Contractor, the Company acquired control of the project, but without the funds the Contractor diverted, leaving the Company with a loss on the project.
- A Contractor with a long standing relationship with a Company needed the Company's indemnity assistance in order to bid projects over a certain dollar amount. As a result, the Contractor's backlog consisted of a mix of bonded projects, the larger ones with the Company's indemnity and the smaller ones without the Company's indemnity. As the Contractor prosecuted this backlog, the Contractor comingled funds from each of these projects, as his cash flow needs dictated. After hitting a cash flow "wall", the Contractor needed financial assistance. Completing its review of the Contractor's projects, the Company discovered that the Contractor's comingling of the funds left the projects it guaranteed in a cash deficit position. In short, because the Contractor comingled the funds, the Company was going to sustain a larger loss than it otherwise would have because the "diverted" funds benefited projects not guaranteed by the Company. The Company, however, was legally obligated to cover the full loss despite the unfavorable comingling of the project funds as that was part of the risk the Company assumed in indemnifying for the Contractor.

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[1] People take risks all the time and are willing to gamble when they think it is appropriate. Many times, people will take risks when they should not but they still do so. The conclusion is that people, generally, are not risk averse, but they are loss averse, which will drive behaviors that lead to irrational decisions and larger losses. The studies that reached this conclusion won the 2002 Nobel Memorial Prize in Economics for their author and led to the establishment of the Prospect Theory. See, *Against The Gods: The Remarkable Story of Risk,* Bernstein, P. (John Wiley & Sons, Inc. 1998). Given this risk taking, but loss averse gene we all have, sometimes the most prudent step to take is the one you make to move a way from the bargaining table so you do not "do a deal" that you may live to regret.

Third Party Indemnity – Suggested tools and approaches for a third party indemnitor

You may be already familiar with the tools and approaches discussed in the paragraphs that follow. On the other hand, when you read this section you may encounter a new take on an old issue. Whether it is something that is old hat or something new to you, we thought it would be beneficial to review a number of tools that might mitigate your risk as a Third Party Indemnitor.

- **Underwrite your business partner.** Although everyone intuitively understands that they need to know who they are conducting business with, underwriting your business partner is something more. When you are providing your indemnity to support that partner's business you need to have a complete grasp of your partner's capacity, capital and character—what surety underwriters call the three "C's". You need to approach your business partner -the Contractor-¬¬ with the three "C's" in mind because that partner does not qualify for surety credit on their own and needs the credit enhancement represented by your indemnity to qualify for a bond.

  In part, capacity means the ability to: (1) properly estimate the cost to complete a project; (2) successfully manage a project both in the field (technical execution of the work, including having the right equipment) and systems-wise (job costs reports, scheduling, accounts receivable, accounts payable, accounting staff); and (3) complete the size of contract (dollar value representing difficulty) for which your business partner needs your indemnity.

  Capital, on the other hand, means what its name suggests: working capital and in particular cash. You need to be concerned about the adequacy of the Contractor's working capital and cash positions in relationship to its overall backlog, and not just the one or two jobs you guarantee. If the Contractor's other projects or other business ventures create a cash drain, then you may find yourself having to fund the completion of projects that otherwise would not need your involvement.

  As part of your capacity and capital review, you need to understand the Contractor's debt position, including trade debt and bank debt. If the Contractor's debt burden is high in relationship to net worth and the Contractor's ability to generate an adequate profit is problematic, as determined using a break even analysis, then you need to know that about those flaws before it's too late.

  As for the last "C", the character aspect of underwriting your business partner is just what you would think: the integrity and reputation of the Contractor's management and owners.

  What is often overlooked is that all three "C's" have to be present. Good character and construction expertise cannot entirely make up for lack of capital, which may be one of the reasons why your indemnity is necessary to support the Contractor's bond requests.

  Although this section's discussion of the three "C's" is a very high level summary of a complex process, the three "C's" highlight the fact that the Contractor needs your indemnity to support its bond request because its capacity and/or capital to complete the bonded project are not adequate. Given these inadequacies, you need to satisfy yourself that you are willing to provide your indemnity on behalf of the Contractor despite these flaws.

- **Joint control account.** A joint control account is a bank account established by at least two parties that restricts disbursements as a means of providing funds control[2]. In order to disburse this account's funds, two signatures are required for each disbursement, one from the Contractor and another from you, the Third Party Indemnitor. The funds deposited in this account come from the bonded contract that the Contractor has secured with the credit enhancement provided by your indemnity for the bond. The Owner of the bonded project deposits contract proceeds into this joint account by wire transfer or other means. Typically, the contractual means used to direct the Owner to make these deposits is a written directive or assignment[3] signed by the Contractor.

  When properly setup and maintained and combined with you actively monitoring the project, a joint control account provides you with a degree of protection from the misapplication of contract funds and unpaid subcontractors and suppliers. Yet, almost as important as what a joint control account can do is what a joint control account can not do.

  Your ability to use a joint control account depends on the nature of the project and the nature of the entity for which you are indemnifying. If the project is a Federal project, and you have provided indemnity to support a disadvantaged business enterprise or similar entity (DBE), then unless you have established a proper mentor relationship[4], the Government may determine that the joint control account allows you too much control over the DBE in violation of federal regulations[5].

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[2] There are many companies that will provide funds control services for a fee. Typically, these services including processing and tracking receipts, disbursements and costs against a budget and securing lien releases. If you elect to retain a funds control company, please proceed with caution. There have been some high profile ethical and business failures related to funds control companies commingling, diverting, and embezzling funds. If you elect to retain a funds control company, you should investigate that company thoroughly and make sure that it has secured the appropriate insurance coverages to protect you, including errors & omissions and dishonesty coverages. Also, keep in mind that these companies typically do not monitor work in the field and will not detect if a job is substantially overbilled or defective work is being performed.

[3] You will need to perfect your assignment pursuant to Article 9 of the U.C.C. in order to establish your priority to the contract funds.

[4] Addressing all the issues that need to be considered when conducting business with a DBE or similar entity is outside of this paper's scope. However, much has been written about partnering with DBE's and other entities via joint ventures, teaming agreements and mentor-protégé' relationships to which reference may be made, including *Government Contracting Programs for Small Disadvantaged Business*, Blackey, C. & McNamara, M. (May 2009), which is available through Travelers.

[5] See, *In re: Apex Ventures, LLC*, SBA No. VET-219 (2011) and *In re: VetIndy, LLC*, No.VET-175 (2010), which both held that the DBE's lack of absolute control over its bank account reflected that the DBE's qualifying individual did not have the requisite control over its daily operations.

If you are supporting a non-DBE entity on a Federal project, however, then you may use a joint control account. Even with a joint control account, however, you still run the risk that the funds may be diverted. The Federal Government does not have a legal obligation to deal with any entity with which the Government does not have a contract, which, in this case, means you. Therefore, if the Contractor elects to change the bonded contract's disbursement terms, and have the contract funds deposited into an account other than the joint control account, you do not have a remedy against the Federal Government. Instead, your only recourse is against the Contractor.

For non-Federal projects, you may have a greater degree of control over the contract funds by having the Contractor assign the bonded contract funds to you and then delivering that assignment to the Owner. A degree of caution is necessary, however, as you should consult with a knowledgeable construction attorney to determine if such an assignment is enforceable against the Owner.

Even with an enforceable assignment, you may have to compete with the Contractor's other creditors for the contract funds. In jurisdictions that grant subcontractors and suppliers stop notice rights against contract funds, those stop notice rights may trump your assignment[6]. Further, the Contractor's bank may have a prior and therefore superior security interest in those contract funds under its loan agreement with the Contractor. If the Contractor defaults on that loan agreement, then the bank has the ability to seize the contract funds and defeat your assignment. Such an outcome leaves you with no future deposits for your joint control account and does not relieve you of the obligation to see the project through to the end.

By the same token, if the Contractor's performance (or lack thereof) causes the Owner to stop paying or delay payments, then the joint control account does not offer a solution. In short, there are no funds to control and the project's costs continue to accrue with no offsetting revenue, leaving the Contractor and you to fund the shortfall.

- **Lien releases and preliminary notices.** You should confirm that the Contractor has setup an effective lien release and preliminary notice procedure to process payments to its subcontractors and suppliers[7]. If you determine that the Contractor's process is not adequate, then you should work with the Contractor to establish an effective process. In either case, you should periodically audit[8] the Contractor's lien release/preliminary notice/payment process to make sure that the Contractor is in compliance with the agreed procedures.

  However, the foregoing does beg a question, which is what is an effective lien release /preliminary notice process? Obviously, a good starting point is how you process payments to your subcontractors and suppliers. Still, you may not want to stop there[9]. You may want to take a fresh look at this issue[10]. If you do so, consulting a knowledgeable construction attorney in your state, or the state in which you or the Contractor may be operating, should help you lay a solid foundation for your revised (or new) payment process. You should ask your attorney to prepare an easy to reference chart that outlines by owner type (Federal, Public, Private) the legal requirements for preliminary notices and bond claim and lien notices by claimant type (subcontractor, sub-subcontractor, supplier, supplier to a supplier, etc.) and contracting tier.

  You may then use this chart to train the Contractor's field and office staff to collect preliminary notices by subcontractor and then "police" that subcontractor's payables by contacting that subcontractor's sub-subcontractors and suppliers to verify payment[11]. In addition, you should train the Contractor's personnel to match payments made to a subcontractor to preliminary notices and lien releases[12] attributable to the contractual tiers below that subcontractor to make sure that that subcontractor is paying its bills. If necessary, the Contractor may use the information gleaned from this policing effort to establish joint check agreements and/or issue joint checks to make sure the subcontractor's subcontractors and suppliers are getting paid.

  By consulting the chart, the Contractor's field and office staff will be able to determine who is obligated to provide preliminary notices or bond claim notices and the effect of their failure to do so. Depending on what the law provides, the failure of a subcontractor or supplier to provide a preliminary notice may completely or partially bar their claim against the Contractor and its bond, which, in turn, insulates you from potential liability.

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[6] California is one such state.

[7] As mentioned previously, funds control companies typically have a lien release process that they provide as part of their services.

[8] How often you should audit the Contractor depends on the size of the contract and your comfort level with the Contractor. You may decide to audit monthly, shortly after the payment process cycle has been completed, or quarterly. In either event, you need to make sure that your agreement with the Contractor grants you extensive audit rights with enforcement "teeth" in the event that the Contractor refuses to let you audit or you discover non-compliance.

[9] You may have a very effective and up-to-date process that does not need any modifications. However, before you provide your indemnity to support a Contractor, you need to make sure that that Contractor's process is as good as yours, and, if not, that the Contractor upgrades its process to match yours before you make any indemnity commitments.

[10] You may want to require the Contractor to bond certain key subcontractors such as the electrical and mechanical trades.

[11] You need to make sure that the Contractor's subcontracts have the correct terms that authorize this type of activity.

[12] To the extent necessary, but particularly if the Contractor is operating in a new state or a state new to you, you should consult with a knowledgeable construction attorney concerning the form of the lien releases you should use and their effect. In some states, a lien release is nothing more than a glorified receipt. In other states, a lien release has "teeth" and means what it says and may bar the claim of a subcontractor or supplier entirely.

- **Subcontract terms if you are performing work.** If you are performing work as a subcontractor, you should not sign a standard subcontract form. The key reason is that you do not have an enforceable right against the payment bond if you do not receive payment[13]. Because you are indemnifying, any payment bond claim you make comes back to you as the ultimately responsible party[14].

  To reduce your exposure, you should structure the subcontract's payment terms to require payment within a certain number of days after the application for payment has been submitted. You should also insert terms that allow you to suspend work if you are not timely paid. Further, if you are not paid on time and in the correct amount, you should provide for the right to terminate the subcontract for convenience or default. Finally, you should make sure that your downstream subcontracts have pay if paid clauses in them, provided that your jurisdiction allows the use of such clauses.

  The combined effect of these terms is to cut your losses upstream, by reducing the amount of your hung receivable, and downstream, by reducing the amount you owe to your own lower tier subcontractors and suppliers[15].

- **Indemnity agreement between third party indemnitor and contractor.** You should negotiate an indemnity agreement with the Contractor and, if you believe it's appropriate, the owners of the Contractor for their personal guaranties. In addition to providing for you to be reimbursed for any payments, your agreement should provide you with the right to complete the bonded project upon default, with the definition of default broadly defined. Given that current information is critical during a project default, your agreement should also provide that you have the right to access the Contractor's books and records and audit and copy those records. There are many more terms that should be included in your agreement with the Contractor and its owners, with the above suggested terms representing just a few key terms[16].

[13] In those states that grant an unpaid subcontractor rights against the contract funds on a public project, you may be able to partially protect yourself by filling a stop notice or that state's equivalent of a stop notice.

[14] The payment bond claim is subject to what is called "circular indemnity", which arises when the party making the claim is the one responsible, ultimately, to pay its own claim. The final outcome is that circular indemnity extinguishes the payment bond claim.

[15] If you exercise any of these rights as a subcontractor, you may cause the whole project to come to a screeching halt. Because you are responsible for the entire project as an indemnitor, you will need to weigh any adverse impact of stopping performance against the benefit of cutting your losses as a subcontractor. At least with the suggested subcontract terms you have the ability to make this decision. Without them, you may be stuck performing for the duration of the project with no way out short of breaching your subcontract and suffering the adverse consequences.

[16] If you are supporting the bond requests of a DBE or a similar entity, then you need to exercise caution as you may not be able to require certain terms in your indemnity agreement. Some terms and controls create compliance issues or may render your agreement with the Contractor unenforceable as an illegal contract. See, *Morris-Griffin Corp. v. C & L Service Corp.,* 731 F. Supp. 2d 488 (E.D. VA. 2010) order vacated December 7, 2011, in which the Court declined to enforce an agreement between an 8 (a) small business concern and a non-8 (a) entity because that agreement's terms violated certain SBA's regulations and was, therefore, an illegal and unenforceable contract.

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