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Surety Bond Quarterly

AN OFFICIAL PUBLICATION OF
THE NATIONAL ASSOCIATION OF
SURETY BOND PRODUCERS

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FORCES TRANSFORMING THE SURETY WORLD

NASBP
Annual Meeting
& Expo Issue

Subcontract Bonds and Subcontractor Default Insurance

Joint Venture Considerations

International Commercial Surety

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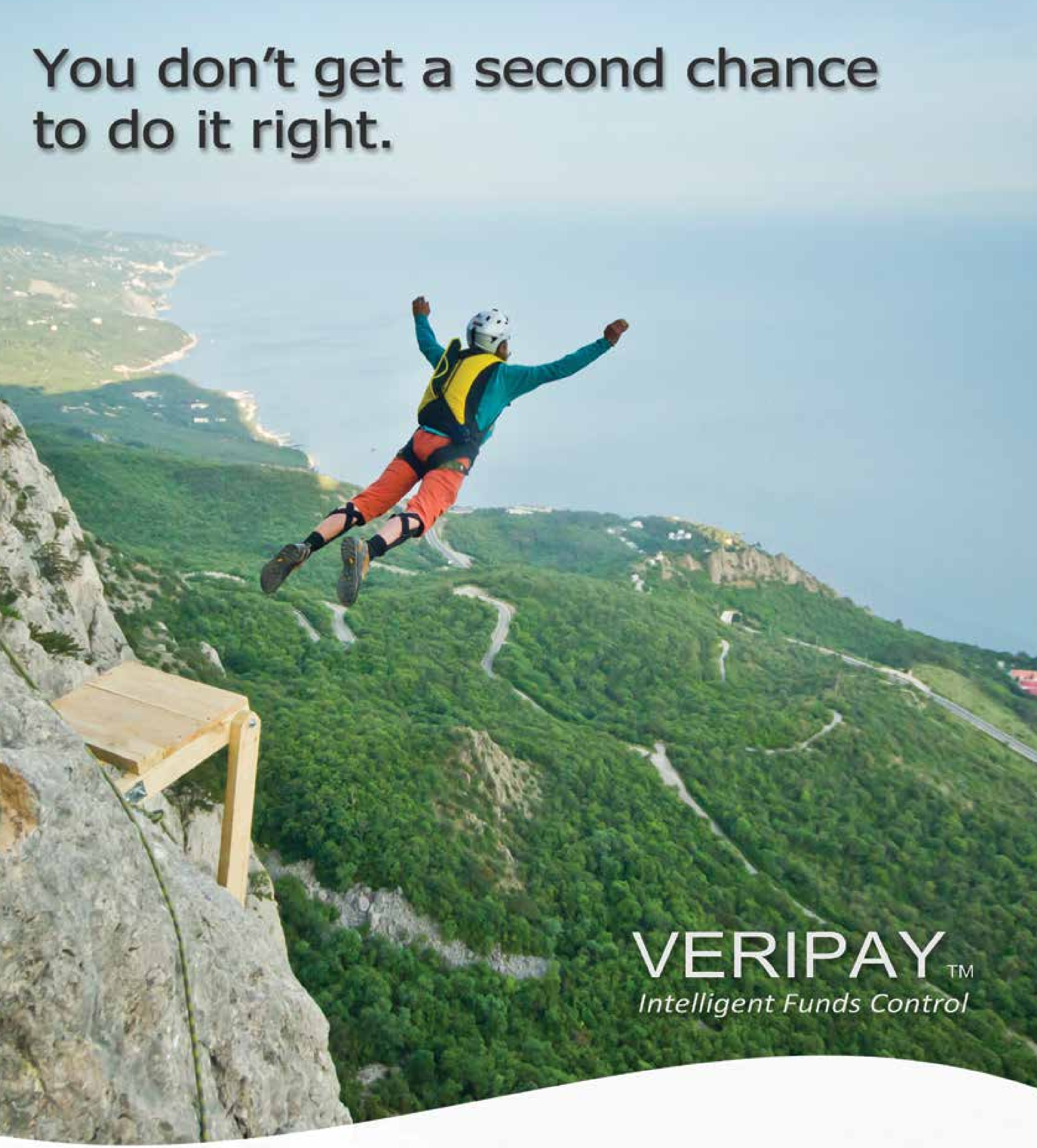

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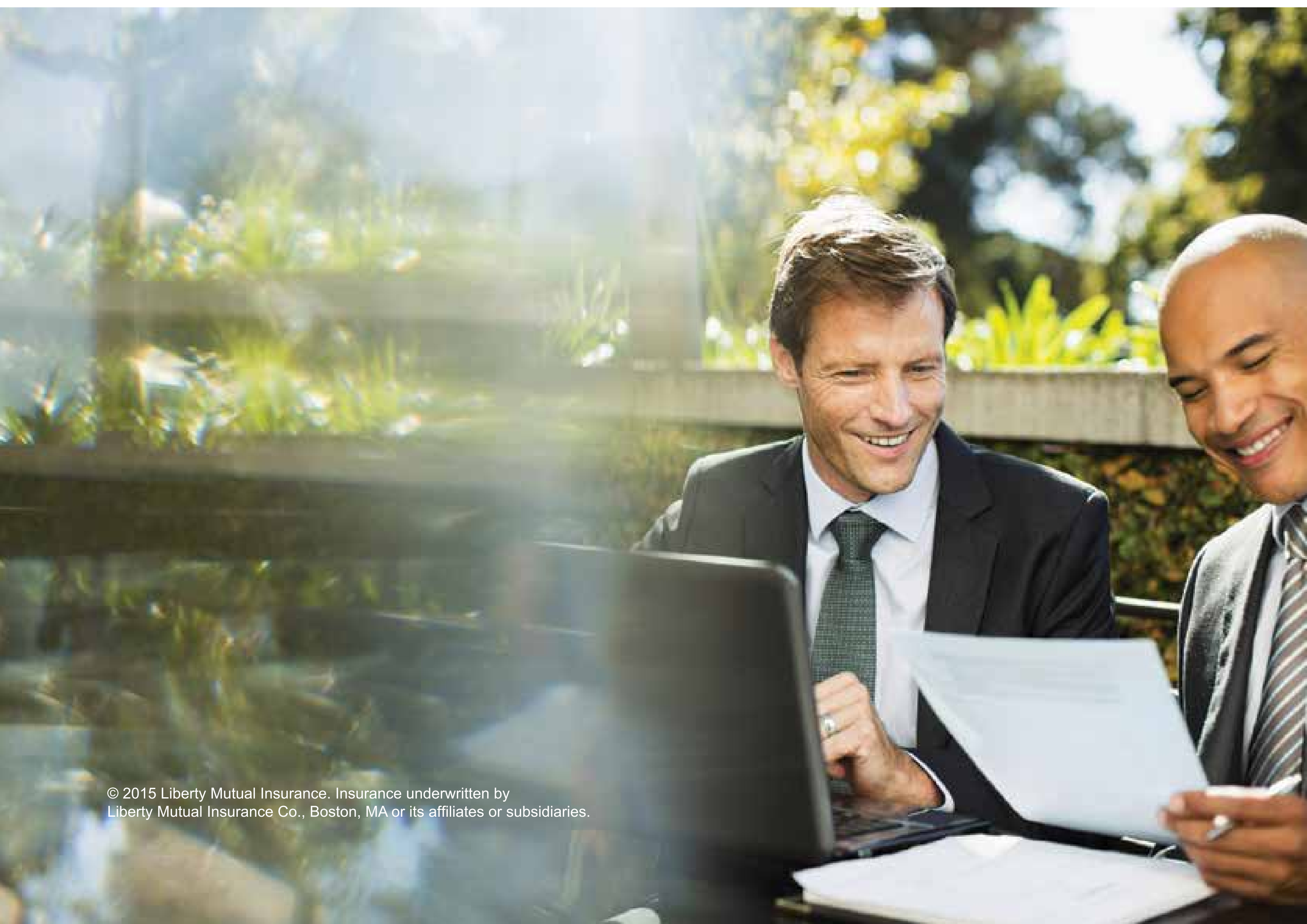

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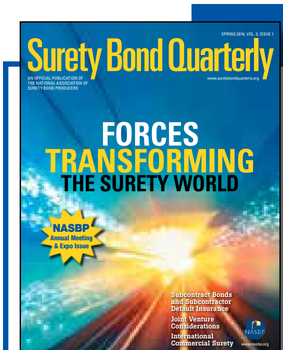

ON THE COVER

SPRING 2016

Forces impacting public project funding and methodologies, technology and information systems, insurance coverage and products, international markets, human resources and the legal system are shaping the surety industry before our eyes. Understanding these transformations is a critical step in planning for the future, and this issue of *Surety Bond Quarterly* serves as your guide on industry trends and the opportunities and challenges that come along with them. As the industry moves full speed forward into a season of change, we hope this issue will provide the tools you need for success.

View this issue, past issues, and Web-exclusive content online anytime at www.suretybondquarterly.org.

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NASBP Upcoming Meetings & Events

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May 15–18, 2016
Colorado Springs, CO

LEGISLATIVE FLY-IN
June 7–8, 2016
Washington, DC

FEDERAL CONSTRUCTION CONTRACTING SEMINAR
June 9, 2016
Washington, DC

SUMMER SURETY SCHOOL— Levels I, II & III
July 31–August 5, 2016
Kansas City, MO

SALES AND MARKETING WORKSHOP FOR SURETY BOND PROFESSIONALS
September 21–22, 2016
Austin, TX

REGIONS 4, 5, 6 & 7 MEETING
September 22–24, 2016
Austin, TX

REGIONS 8, 9, 10, & 11 MEETING
October 2–4, 2016
Nashville, TN

REGIONS 1, 2, 3 MEETING
October 6–8, 2016
Napa, CA

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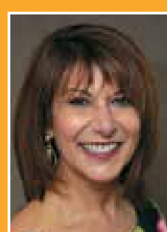

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From the CEO

It's Spring and a Season of Change for Surety

What do we associate with the spring season? Spring certainly is the season of transformation, when the cold, dormancy of winter gives way to warm change, and, with the right, cultivated conditions, emergence and renewal. Spring can mark a time of both desirable and undesirable changes. Careful planning, assessment, and preparation are necessary to ensure that changes move in the right direction. For instance, as winter turns to spring, federal and state legislatures swing into high gear, necessitating that the surety industry carefully monitor legislative and regulatory developments and refresh or renew relationships with policymakers, public officials, and industry partners cultivated over past seasons. Opportunities emerge, as do challenges. What becomes of greatest import are the attitudes we assume and the actions we take in response to those inevitable challenges that portend some measure of consequence for our future.

Surety is in its season of change. Surety is being buffeted, intentionally and unintentionally, by significant transformations in public project funding, public procurement methodologies, technology and information systems, insurance coverages and products, new international markets, worker talent shortages and generational changes, and legal developments. Cultivating our proverbial garden without taking stock of such transformations may translate to diminished industry stature or worse. Gaining a greater understanding of these transformations and of differing perspectives is critical to being prepared for a positive future. To that end, this issue of the *Surety Bond Quarterly* examines some of the forces and trends that are transforming and will continue to transform our surety world.

Among the topics highlighted in this issue is that of subcontractor default insurance. NASBP recently produced a white paper focusing on the distinctions between subcontractor default insurance and subcontract bonds, which is republished in this issue. CFMA National Chairman and LendLease Head of Treasury Services J. Brad Robinson, an officer of a large construction firm, shares his personal perspective on his firm's use of subcontractor default insurance and subcontract bonds. Bill Ernstrom, Vice President for Major & Strategic Projects for Walsh Construction Company, offers his company's views on why subcontract bonds are a preferred means to address the risk of subcontractor default over subcontractor default insurance. Attorney G. Scott Walters of the law firm of Smith Currie and Hancock examines a recent legal decision that conveys the burdens faced by an insured as a result of its obligation to recover monies under a commercial general liability policy for the benefit of the insured's subcontractor default insurance carrier.

Over the last decade changes in the construction procurement environment have accelerated, particularly how companies associate with one another to pursue contract awards and the myriad compliance burdens they face in the context of public construction work. This changing landscape necessitates that surety professionals remain conversant, so they may provide helpful counsel where and when appropriate. To that end, Michael C. Zisa, a partner in the law firm of Peckar & Abramson, provides practical insights on the use of construction joint ventures, while attorney W. Barron A. Avery with the law firm of Baker Hostetler lets us know the surprising relevancy of anti-human trafficking compliance to construction firms.

The internationalization of surety markets, both for contract and commercial surety, has become more pronounced. International underwriting issues and opportunities are on the minds of more sureties. Surety professionals experienced in this area provide valuable insights on the considerations surety professionals should know when arranging for a commercial bond to be written outside of the United States.

Spring is a time of new possibilities. I hope the articles in this issue underscore not only the transformation of surety and the various elements playing a role in that transformation but also the tremendous opportunities we can seize for our clients and for our industry's future.

Warmest regards,

Mark H. McCallum
NASBP CEO

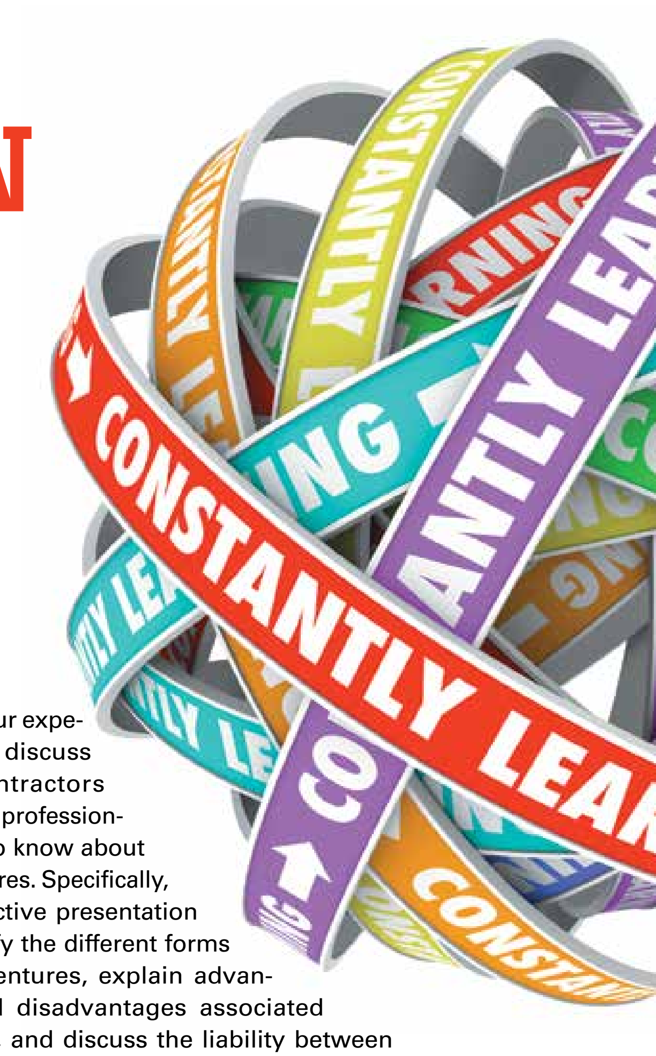
2016 NASBP Annual Meeting Session

PRACTICAL INSIGHTS: WHAT YOU NEED TO KNOW

Joint Ventures in CONSTRUCTION

BY MICHAEL C. ZISA

The following is an introduction to the continuing education (CE) course for bond producers that will be held at the NASBP Annual Meeting & Expo and NASBP Regional Meetings.



A JOINT VENTURE is a partnership between one or more companies to take on a commercial enterprise. Joint ventures have been used in the construction industry for years but have become increasingly common as projects continue to become larger, more complicated, and more specialized. There are a number of reasons joint ventures are appealing in today's construction market—joint ventures allow companies to share risks, resources, knowledge, and expertise and increase bonding capacity and market reach. For example, a large construction company may have the experience, resources, and bonding capacity to perform a megaproject but have concerns because the project is located outside of its typical geographical market. A smaller contractor may have knowledge and experience regarding the local market but not the experience, resources, or bonding capacity to compete for the megaproject on its own. A possible solution: a joint venture that allows the contractors to partner and pool their respective strengths to pursue the megaproject.

While the opportunities presented by joint ventures are enticing, contractors (and sureties providing bonds to the joint ventures) must understand and carefully consider a number of factors before taking the leap into the world of joint ventures. At NASBP's Annual Meeting & Expo in May in Colorado Springs, CO, a panel of attorneys from the national construction law firm of Peckar & Abramson will draw on our experience to discuss what contractors and surety professionals need to know about joint ventures. Specifically, the interactive presentation will identify the different forms of joint ventures, explain advantages and disadvantages associated with each, and discuss the liability between the partners to the joint venture. We will also explain the distinctions between a joint venture agreement and a teaming agreement.

The panel will also discuss the essential terms of the joint venture agreement—from basics such as members, purpose, ownership, and duration to more complex issues and terms involving capitalization, management, profit sharing, default, indemnification, and dispute resolution. How will the joint venture be financed at the outset and during performance? Who will serve as the managing partner and who will manage the day-to-day operations of the joint venture? What are the voting requirements for different types of joint venture action? How and when will profits and losses be shared? What happens when one of the partners is in default under the terms of the joint venture agreement? How will disputes between the joint venture partners be resolved? These are all essential questions that must be carefully considered and addressed in the joint venture agreement in order to avoid costly disputes between the joint venture partners. The panel will use real-world experiences to discuss these topics.

An area where joint ventures opportunities have flourished is with federal government programs such as the Small Business Administration's 8(a) program that "sets aside" contracts for qualified small and disadvantaged businesses. The joint venture relationship in this area raises a myriad of compliance issues that contractors and sureties must understand in order to stay out of trouble. The panel will discuss the requirements of these programs along with other special joint ventures topics, such as design-build joint ventures and mentor-protégé joint ventures.

Finally, the panel will address issues and considerations for sureties and surety professionals when bonding a joint venture. It will explain the underwriting process, which includes review of the capacity, capital, and character of all partners in the joint venture and the terms of the joint venture agreement. You'll learn about an "angel deal" and why it raises red flags in the underwriting process. We will also discuss the typical indemnity requirements for bonding a joint venture and key practical issues that bond producers must understand when assisting clients to obtain bonds for a joint venture.

The presentation will be chock-full of useful information that will help bond producers and other surety professionals identify issues for your clients that are considering taking the leap into the world of joint ventures.

Michael C. Zisa is a partner in the Washington, DC office of Peckar & Abramson, P.C. and focuses his practice on construction, surety, and government contracts law and chairs his firm's Surety Practice Group. Zisa was recently recognized again by Washington, DC Super Lawyers in the areas of construction litigation, surety and government contracts. Zisa, along with several colleagues from his firm, will once again jointly present with NASBP the "Federal Construction Contracting Seminar," which will be held this year on June 9 in Washington, DC. Register at www.nasbp.org. Zisa can be reached at mzisa@pecklaw.com or 202.293.8815.

MAKING A DIFFERENCE
NASBP Members Support Breakthrough in Trauma Treatment for Vets

LAST YEAR, AT NASBP's 2015 Annual Meeting, former soldier Doug Bauldwin spoke about his struggles with post-traumatic stress (PTS) and the breakthrough treatment that turned his life around. His story inspired an outpouring of support from NASBP members. In less than a year, with contributions still coming in, individuals, agencies, and surety companies have raised more than $120,000 to support studies that could make this ground-breaking treatment available to other active warriors and veterans. But there's still more work to be done.

From left, former soldier Doug Bauldwin and J. Spencer Miller of Schwartz Brothers Insurance Agency.

Pictured are attendees at the 2015 NASBP Annual Meeting, from left, Rear Admiral Denny Wisely (ret); Jeffrey Hecker, spouse of NASBP President Susan Hecker; Kathy Murphy of the Blue Angels Foundation; Carl Dohn of Dohn & Maher Associates; and Thomas Padilla of HUB International Insurance Services of Albuquerque, NM.

A FORMER BLUE ANGELS FLYING TEAM LEADER AND CHAIR OF THE CHARITABLE BLUE ANGELS FOUNDATION, WISELY WAS DETERMINED TO BRING THE PROGRAM TO OTHER SERVICE MEMBERS SUFFERING FROM PTS.

From left, John Knox and Steve Nelson of SureTec Insurance Company.

NASBP's involvement with the PTS treatment program started with Tom Padilla, 2014-2015 NASBP President. To highlight his year's theme, "Make a Difference," he wanted to showcase and support veterans' groups at the national convention. Not only was the meeting in San Diego, home to a large naval base, but also he, his father and now his daughter have served in the military. "Plus, as an industry, what we bond is mostly government projects and a huge number of them are military," Padilla said.

Padilla asked retired U.S. Navy Vice Admiral David Buss to serve as keynote speaker.

"Tom told me that they were looking for a cause to get behind, and asked if I could suggest anything," recalled Buss. He had the perfect recommendation. Just a few months earlier, retired U.S. Navy Rear Admiral Denny Wisely had told Buss about a new, non-drug protocol for treating PTS, pioneered by Dr. Frank Bourke, executive director of the Research and Recognition Project. Wisely had seen Bourke's program work for two veterans in San Diego.

"The results were astounding," Wisely said. A former Blue Angels flying team leader and chair of the charitable Blue Angels Foundation, Wisely was determined to bring the program to other service members suffering from PTS. Bourke had completed a very successful 30-person study in New York State, but he needed to conduct many more tests to win acceptance of the protocol from the medical community. "I started on a mission to fund another 30-person study with vets in the San Diego area," said Wisely. After learning about Bourke's work, Padilla knew he had found a cause NASBP could support.

At the end of Buss' NASBP keynote address, he introduced Bauldwin, who spoke about his 5½ years in the Army. During his time in Iraq and Afghanistan, Bauldwin survived 14 IED explosions, firefights lasting 24 hours and longer and the loss of many friends. When he came home, Bauldwin, like many other service members, had nightmares and couldn't sleep, function in society or relate to people. "It can be overwhelming," he said during his talk. "Just trying to get out of bed every day can be almost impossible."

Then Bauldwin worked with Dr. Bourke. "After going through just the first of the three sessions, I was able to sleep for six hours straight for the first time in six years," Bauldwin said. "By the end of the third session

I was ecstatic; I couldn't stop smiling. The change that happened over those three days—and continues to happen—just blows me away every day."

A treatment that works

Bourke, a clinical and research psychologist with more than 40 years of experience, refined his PTS protocol while treating more than 800 survivors of the 9/11 World Trade Towers attack. The treatment has successfully treated, without drugs and in less than five hours, the symptoms of PTS—nightmares, flashbacks and directly related emotional problems. In the first pilot neurological measurement using EEG before and after RTM treatment, the physical indications of its presence in the brain decreased sufficiently to remove the indication of PTS. "This really isn't therapy in the classical sense. This is a neurological intervention that is done by talking to people and having them reimage their traumatic memories," he explained.

Bourke uses the example of someone traumatized by a lion attack. Remembering the event nightmares and flashbacks helps the brain ensure that the person will avoid lions in the future. "It's not meant to be under your intellectual, neocortical control; you're not supposed to get rid of it," Bourke explains. "It's implanted in a portion of the brain that isn't up for negotiation, implanted with a very clear visual memory and auditory and kinesthetic memory."

The key is to reprogram the brain so those memories no longer engender fear. The first part of the process is disassociation—helping the person imagine they are watching a black-and-white movie of the attack from a seat in a movie theater. Then Bourke assists the person in altering the way the picture is stored. "We have them run it backwards very quickly; instead of the lion 10 feet away, ready to jump, they run the movie backwards until they get to the part where they were safe, before it all began," he explained. "What you've done is made the movie that's stored in your brain, which normally goes forward and freezes at the height of the terror, go backwards past the terror with no feeling," Bourke said. We believe, the separation between the images and the traumatic feelings is neurological, based on a neurological process called Reconsolidation.

In the first two studies in New York and in San Diego, the Research and Recognition team was able to eradicate the PTS symptoms in 96 percent of the 60 veterans who participated. There are several other studies underway, but millions of dollars are still needed to complete them. Looking for a neurological laboratory to help with the research, Bourke was able to connect with Dr. Jeffery D. Lewine from the Mind Research Network located on the campus of the University of New Mexico. Lewine has agreed to let Bourke and his team use his state of the art neurology laboratory to document the significant changes made in the brain after the PTS treatment.

"We want to do extensive scientific research until no one can doubt what we have; we want this to be classified as evidentiary medicine," said Bourke. The goal is to get the protocol accepted by the Veterans' Administration and provide relief for the thousands of active and former service members suffering from PTS.

Ongoing support

After hearing about Bourke's work, "Spence Miller [2010–2011 NASBP President] made a challenge from the podium for everyone to donate at least $500," said Padilla. Then, John Knox, CEO of SureTec Insurance Company, promised to match, dollar-for-dollar, the contributions made at the meeting. Both Admiral Buss and Jerry Lujan, another speaker, donated large portions of their speaker fees to the effort. NASBP members in attendance contributed generously, as well. That totaled $37,500. Originally, Padilla had hoped to raise $20,000–$30,000, but soon realized contributions had quickly surpassed that target goal. "With SureTec's contribution, we were able to contribute, through the Blue Angels Foundation, an initial $75,000 towards the project," said Padilla.

"We look for ways to give back, and this fit a lot of criteria," said Knox. "Here was a program that many of the best surety bond producing agents were excited about, and we got to meet the admirals who were excited about it, too. It was a wonderful opportunity. The money is important, but it's also important when you pull together people who are focused on doing the right thing."

Pledges continued to come in. "Merchants Bonding Company, Chubb Surety, Liberty Mutual Surety and CNA Surety Corporation all gave additional significant contributions," said Padilla. To date, total contributions resulted in over $120,000 contributed to PTS studies. With the Blue Angels Foundation supplying the additional funding, Bourke completed the San Diego replication study, achieving amazing results with 30 veterans (93 percent symptom remission).

Wisely, meanwhile, has been impressed with NASBP's commitment. "This group of people at NASBP have hearts; they are all patriots, and they are all in," he said. "This is good corporate citizenship, to give something back to a group that has given so much to our country," said Padilla. "It's the right thing to do for our country and our vets."

Learn more about Dr. Bourke's work and see moving video and written testimonials at http://www.researchandrecognition.org. To make a contribution, or obtain more information, contact Tom Padilla at Tom.Padilla@hubinternational.com or donate via http://www.researchandrecognition.org and mark it "PTS Project/NASBP fundraising." To view video testimonials of veterans who received the RTM treatment, visit the research and recognition website at http://www.researchandrecognition.org/.

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Feature

SUSAN HECKER

Recognized for Contribution to Heavy-Construction Industry

In January, Susan Hecker accepted the Golden Beaver Award for Service and Supply from 2015 Beavers President Wilford Clyde of Clyde Companies.

ON JANUARY 22, 2016, The Beavers, a national heavy-engineering construction trade association, recognized Susan Hecker, Executive Vice President and National Director of Contract Surety at Arthur J. Gallagher & Co. in San Francisco and NASBP President, for her outstanding contribution to the heavy-construction industry by presenting her the Golden Beaver Award for Service and Supply. The Beavers recognized Hecker for demonstrating particular skills, responsibility, and integrity in her profession as a surety broker in the construction industry.

"Susan was nominated and chosen for her career-long record of serving her clients," said Beavers Executive Director Dave Woods, who added that "Hecker has earned a reputation as a trusted adviser, consultant, and partner to many contractors." Hecker accepted the award during the Beavers Awards Dinner, an annual gathering of heavy-construction contractors, which had 2,375 in attendance.

NASBP Second Vice President Howard Cowan of Cowan-Hill Bond Agency Inc. in Lubbock, TX, remarked, "Susan has earned respect across the nation for her energy and professionalism." It is noteworthy that after receiving the Golden Beaver Award in Los Angeles, she immediately traveled to Houston to lecture in the NASBP Surety Schools, and from there she traveled to the AGC/NASBP/SFAA Joint Surety and Risk Management Conference to conduct a presentation on ethical dilemmas faced by contractors and sureties," Cowan said. "It is easy to understand why she is admired and respected by the construction industry."

For more information, see the November 21, 2015, *Engineering News-Record* article, "Moles and Beavers Name Top Honorees for 2016."

Feature

EVOLVING COMPLIANCE REQUIREMENTS: Addressing Human Trafficking

BY W. BARRON A. AVERY

AS SET FORTH in the Winter 2015 edition of *Surety Bond Quarterly*, federal government contractors must comply with various contract requirements, such as limitations on the ability to subcontract and requirements on the wages paid to employees. Contractors' failure to comply with these requirements places contractors at serious risk, with liability under the civil False Claims Act, suspension, debarment, and contract termination. This article addresses the new compliance obligations relating to human trafficking and is the second in a series of articles that address the hot topic of federal government contract compliance.

Most federal construction contractors hear the term "human trafficking" and immediately believe that their businesses have nothing to do with the practice and that they should not be concerned with the issue. Nothing could be further from the truth. While human trafficking may not be on most construction contractors' radar screens, recent developments in federal policies and procurement regulations should have all contractors paying particular attention to this quickly developing topic. Recent amendments to the Federal Acquisition Regulation, in addition to the President's announced intent to enforce these regulations, mean that contractors must take affirmative actions to comply with the law in this area and mitigate their risk for non-compliance.

Set forth below is a discussion of important federal regulations addressing human trafficking in federal procurement of which surety professionals and their contractors should be aware, two case studies that highlight the importance of complying with current human trafficking policies and legislation, and conclusions for surety professionals and their contractors.

A. Anti-Human Trafficking Compliance Requirements are Stringent

In recent years, the federal government has taken a keen interest in identifying and preventing human trafficking, with the government identifying human trafficking as both sex trafficking and labor trafficking. With the goal of preventing human trafficking, the government has identified a number of activities that are associated with human trafficking, and the government has chosen to advance its stated policy of preventing trafficking by imposing restrictions on contractors.

In 2015, the Federal Acquisition Regulation (FAR) Council issued a final anti-trafficking rule that prohibits contractors from engaging in certain activities. Under the FAR, contractors must adhere to a "zero-tolerance policy" that prohibits them or their subcontractors' employees from (1) engaging

in "severe forms of trafficking," including both commercial sex and coercive labor trafficking; (2) procuring commercial sex acts; (3) using forced labor in the performance of contracts; (4) preventing access to an employee's identity or immigration documents; (5) using misleading employee recruitment practices or recruiters who do not comply with local laws; (6) charging employees recruitment fees; (7) failing to provide employees with return transportation at the end of employment; (8) housing employees in conditions that violate local law; and (9) failing to provide an employment contract in writing. In addition, the FAR also requires certain contractors to maintain a compliance plan designed to detect and deter human trafficking.

B. Consequences for Compliance Failures are Severe

Penalties for violating these prohibitions are severe. Contractors may be terminated, suspended and debarred, or face civil liability and penalties for violations. Moreover, the threat of these penalties is heightened by increased enforcement of the anti-trafficking rules, where certain contractors found in violation have paid a high price, both to their finances and to their reputation. Two recent examples highlight this area of concern.

In July 2011, ArmorGroup North America (ArmorGroup) and its affiliates paid the government $7.5 million to settle False Claims Act allegations that the company submitted false invoices regarding charges for its services to protect the U.S. embassy in Kabul, Afghanistan. The settlement resolved allegations that ArmorGroup violated the Trafficking Victims Protection Act, a precursor to the FAR's anti-trafficking regulations addressed above, by ignoring calls that its employees frequented brothels that might have been engaged in sex trafficking. Under the False Claims Act, the government may have been able to recover up to three times the amount of the false invoices, plus civil penalties.

Further, in 2015, Signal International (Signal), a U.S. shipbuilding and oil rig repair firm with multiple government contracts, agreed to pay approximately $20 million to resolve all human trafficking lawsuits involving exploited Indian guest workers. Signal sought additional workers to repair storm-damaged oil rigs in the aftermath of Hurricane Katrina. Workers claimed that Signal colluded with recruiters to lure them into the U.S. to work as welders and pipefitters under a guest worker visa program. It was alleged that workers were falsely promised permanent U.S. residency and were each charged thousands of dollars in recruitment and travel fees to work in the U.S., only to find themselves forced into involuntary servitude. Workers paid Signal $1,050 per month to live under inhumane conditions in guarded and overcrowded labor camps.

Accordingly, with these steep penalties and the clear ongoing efforts to enforce anti-trafficking laws, contractors are well-advised to comply with anti-trafficking requirements.

C. Conclusions for Surety Professionals and their Contractors

As addressed above, the failure to comply with human trafficking laws can result in severe ramifications. Termination for default, suspension and debarment, and False Claims Act and civil lawsuits may be used against a non-compliant government contractor, with any one of these mechanisms capable of serving a crippling blow to a contractor's business. Therefore, surety professionals should advise their contractors to pay particular attention to their responsibilities and obligations in connection with the anti-trafficking regulations. In this regard, construction contractors should conduct a "housekeeping" check to ensure that they are in compliance with the new requirements and keep in mind several important elements of the new anti-trafficking requirements. Specifically, construction contractors should:

- Confirm that contracts contain anti-human trafficking requirements, specifically whether contracts contain FAR 52.222-56, Certification Regarding Trafficking in Persons Compliance Plan, or FAR 52.222-50, Combating Trafficking in Persons;
- Notify employees and subcontractors of the activities in which they cannot engage under the government's zero-tolerance policy;
- Notify employees of the actions that can be taken against them in the event they violate that zero-tolerance policy;
- Prepare and implement an anti-human trafficking compliance plan consistent with the FAR's requirements; and
- Contact knowledgeable counsel in the event employees engage in any activity that could violate the government's zero-tolerance policy.

With these measures, construction contractors can significantly reduce their risk of non-compliance with the federal government's new anti-human trafficking requirements.

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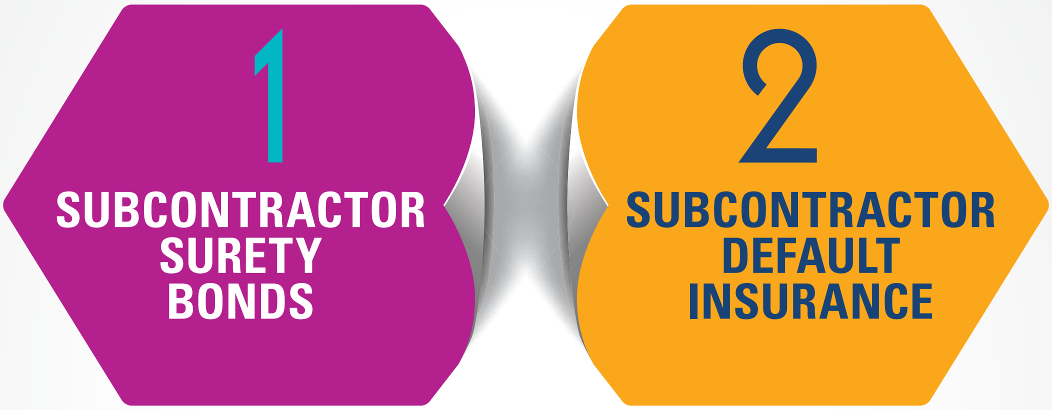
Be sure to read Avery's next article in the Summer 2016 edition of *Surety Bond Quarterly* on designated business entities requirements in prime contracts and recent developments in DBE-related fraud and enforcement.

Feature

Subcontractor SURETY BONDING and DEFAULT INSURANCE

The Value (and Risk) of Using Both Resources



BY J. BRAD ROBINSON

WHEN I AM not fulfilling my obligations as the national chairman of the Construction Financial Management Association, I am employed by an international construction manager/general contractor within the finance department. One of my responsibilities is to ensure that our subcontractors are financially sound to perform on our projects. In order to do so, we use both subcontractor default insurance (SDI) and subcontractor surety bonds. I am convinced that **both** are beneficial risk mitigation products **if** they are used in the correct manner.

An SDI program may be attractive to a contractor because of the perception that sureties are typically slow to react to claims AND the potential for additional profit, provided that default reserves reach an acceptable level and losses are minimal. However, this lure of additional profit can be deceiving. It takes a high level of sophistication to actively manage the risk of potential subcontractor default. Best-in-class contractors typically have a function that manages the overall SDI product (enrollment, renewals, claims, etc.) and someone who assesses the financial risks of accepting the subcontractors and their capability of executing the type and size of subcontract they are entering into. My company has been quite conservative in the underwriting and prequalification of our subcontractor partners, and as such the program has been financially and operationally successful. We understand and recognize that we cannot see the same depth of information to which a surety has access through due diligence and underwriting within their bond program and thus the conservatism we maintain. Committing to an SDI program is not inexpensive in terms of the quality of staffing and resources, let alone large self-retention and co-sharing in losses with the SDI carrier. This is a primary reason only mid-size to large contractors, those that have loss absorption power, engage in SDI programs. If the contractor is not adequately resourced and prepared, with adequate loss funding reserves, then the outcome could be devastating.

What about subcontractor bonding? My company relies on subcontractor bonds when we cannot get comfortable with the empirical data that we have obtained to underwrite the contractor. Generally, the subcontractors with whom we have had the most experience and those trades with the lowest risk of default are those we use to prequalify with SDI. For the balance, we utilize surety

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Feature

Managing Subcontractor

RISKS OF NON-PERFORMANCE AND FINANCIAL FAILURE

A Flash Guide to Subcontract Bonds and Subcontractor Default Insurance

THE PRINCIPAL MEANS of mitigating subcontractor default risks is through a process of subcontractor prequalification. For more than a century, surety companies have provided regular, in-depth third-party prequalification services to general contractors by extending surety credit to subcontractors through bid, performance, and payment bonds. Those subcontractors that merit surety credit receive guarantees of performance and payment in the form of subcontract surety bonds, three-party contracts, which are, in turn, provided to prime contractors upon subcontract award. Only a subcontractor determined by the surety under its underwriting criteria to be fully capable of performing its subcontract obligations is accorded surety credit. The surety closely examines the wherewithal of each subcontractor: its financial strength, credit history, project experience, reputation, progress on other subcontracts, management capability, equipment, size and geographic location of work, and other factors. It is a thorough and confidential process centered on the subcontractor's history of performance and its on-going work program and focused on the crucial tenet of preventing incidences of subcontractor default from the onset. Bonded subcontractors are further incentivized to complete subcontract obligations, as sureties, believing their bonded subcontractors are capable of performing, require personal and corporate indemnities from those subcontract firms in the event that the sureties have to pay out under the bonds.

Subcontractor prequalification also is a component of a two-party, catastrophic insurance policy, subcontractor default insurance (SDI), first developed approximately 20 years ago, to provide general contractors with insurance coverage for direct and indirect costs of trade contractor default. Some general contractors, generally those with subcontract volume exceeding $50 million, that are eligible for SDI coverage see it as an alternative to the purchase of subcontract bonds. Unlike subcontract bonds, SDI is traditional insurance that presumes some level of losses; and general contractors that purchase SDI coverage must bear a significant level of self-insurance for such risks through high deductibles and co-payment requirements. The burden of subcontractor prequalification is borne by the insured general contractor, which must make a substantial investment of resources to create an adequate company infrastructure and culture to ensure proper prequalification of subcontractors. Such a structure is incented by the fact that the insured general contractor will need to build a reserve to pay for deductibles and any co-payments arising from enrolled subcontractor losses in its SDI program. Little or no losses in the SDI program eventually translate into higher margins for the insured general contractor. On the other hand, significant losses can jeopardize the operational ability of an insured general contractor that will bear the expenses of the deductibles and the co-payments and the significant burden of administering claims. The benefits of SDI flow only to insured general contractors, but such benefits can be significant if the insured contractor strictly maintains a well-managed, sophisticated SDI program, with few or no losses.

It is critical to understand that SDI, as a product very different from surety bonds, never is a replacement for statutory federal, state, or local bond requirements, whether such statutory requirements dictate bonds at the prime or subcontract levels. Bond statutes have been in place for many decades and were enacted on well-affirmed public policy grounds: specifically, performance bonds protect publicly funded investments in construction by furnishing public owners with first-dollar coverage for contract defaults; and payment bonds provide specific project parties, various downstream subcontractors and suppliers furnishing labor, materials and equipment, with payment remedies in the event of their nonpayment. Trade contractors, which are not in privity with project owners, have no other payment recourse than the payment bond when they go unpaid on public work, as mechanics' liens are not available against public property. These fundamental public policy reasons for statutory bond requirements are not answered by the general contractor's SDI program.

The following chart is a broad overview of features and purposes of subcontract bonds and SDI. Following is a point-by-point comparison of key aspects of each, providing further insights and additional paths for self-directed inquiries of the respective products, helping an assessment of their suitability for any given situation.

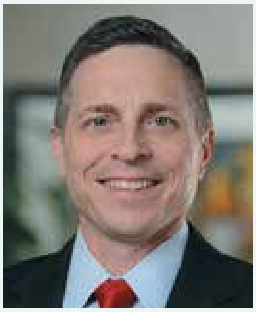
The Features and Purposes of Subcontract Bonds and SDI

ISSUE	PERFORMANCE AND PAYMENT BONDS	SUBCONTRACTOR DEFAULT INSURANCE
Prequalification Process	Conducted by the surety, a knowledgeable third party (extensive and ongoing)	Conducted usually by the general contractor, not a third party
Structure	3-party agreement (general contractor, subcontractor, and surety)	Two-party agreement (general contractor and insurer)
Regulation	Sureties are admitted and regulated by state insurance departments, regularly filing rates and financial information	May be written on non-admitted or surplus lines basis and, therefore, no recovery under state guarantee fund
Risk	Complete risk transfer from general contractor to surety, with first-dollar coverage	General contractor retains a portion of risk through high deductibles and co-payments
Payment Protection for Subcontractors and Suppliers	100% payment bond, with first-dollar payment benefit for subcontractors and suppliers	No payment benefit for subcontractors and suppliers
Subcontractor Default Management	If subcontractor defaults, surety completes, arranges for, or pays for subcontract completion up to bond amount	General contractor must manage subcontractor default, including completion of subcontractor's work
Payment of Losses	Surety pays losses after independent investigation	General contractor must pay losses and then submit documentation to recover from the insurer
Legal Precedents	Extensive history of case law/legal precedents	Little or no case law/legal precedents
Confidentiality of Subcontractor Information	Subcontractor has confidential and on-going relationship with surety	Many subcontractors are uncomfortable providing sensitive financial data to the general contractor (who might be their competitor bidding on the next project)
Premium	Cost is calculated based on contract amount, depending on size and type of project	Cost is calculated on general contractor's program costs and the deductibles and co-payments selected
Cancellation	The bonds cannot be cancelled	SDI can be cancelled by the insurer
Indemnity	Subcontractor is incented to perform by its indemnification obligation to the surety	SDI provides no such incentive other than for the subcontractor not to be sued by the insurer
Limits	Combined performance and payment bonds are equal to 200% of the contract amount	Policy subject to aggregate limit and per loss limit; sublimits also may apply, such as three or four times the subcontract value
Unseen Assistance	Sureties, with the expectation of no losses, provide assistance to bonded subcontractors through financing, engineering, and operational services	Insurers, with an expectation of losses, provide no assistance to subcontractors

Feature

SDI Insured Must Shoulder Burden to

PURSUE CLAIMS AGAINST CGL POLICY



BY G. SCOTT WALTERS

SUBCONTRACTOR DEFAULT INSURANCE (SDI) is one tool in the general contractor's risk management arsenal–particularly on larger, more complex construction projects. SDI typically does not guarantee subcontractor performance and payment as more conventional surety bonds; instead, SDI insures the project's general contractor against the added cost/risk of contractual default by a subcontractor. Most SDI policies contain high aggregate limits to insure against the added cost of subcontractor defaults on multiple projects being performed by the insured general contractor. SDI is generally not a replacement for more traditional general liability (CGL) coverage insuring against the risk of defective work. A recent federal court decision raises some concern, however, that an SDI policy may be used as a funding scheme for the insured to recover for a subcontractor's defective work claims. In allowing this approach, however, the SDI-insured is at risk for expending significant additional time and expense to recapture these funds for the SDI insurer.

Pavarini Construction Co. (Se) Inc. (Pavarini) served as the general contractor on a high-rise condominium construction project in south Florida. As part of the project, Pavarini enrolled in an Owner-Controlled Insurance Program (OCIP), which provided CGL coverage. Two insurers furnished the CGL coverage–one primary and one excess–totaling $29 million in aggregate coverage. Pavarini also carried SDI with $25 million in aggregate coverage.

Pavarini subcontracted portions of its work on the project. One subcontractor, Alan W. Smith, Inc. (AWS), was responsible for building the project's concrete masonry wall units with reinforced steel. Another subcontractor, TCOE Corporation (TCOE), subcontracted to install reinforcing steel within load-bearing concrete columns, beams, and shear walls. Both of the subcontractors performing this work were extended CGL coverage under the OCIP. Additionally, Pavarini's SDI policy covered it against the risk of contractual default by these subcontractors.

Inspections revealed significant defective work performed by AWS and TCOE. This defective work compromised the structural integrity of

the entire building, causing destabilization within other building components. The project owner demanded that Pavarini repair these defects. Ultimately, Pavarini incurred more than $25 million in direct costs to remediate this defective work and to repair other construction work that was impacted by these defects. Pavarini demanded indemnification from its subcontractors for the added costs to repair their defective work and other affected work. Pavarini and AWS also sought coverage for these repairs under the OCIP's CGL policies. Both of the CGL carriers initially denied coverage. This denial of coverage apparently contributed to the contractual defaults of AWS and TCOE, thus triggering the SDI policy.

Under the SDI policy, Pavarini had to pay roughly the first $1 million in damages. Thereafter, the SDI insurer agreed to make payments to Pavarini to fund the repairs. In exchange for these payments from the SDI insurer, Pavarini had to seek reimbursement from the CGL insurers. Eventually, Pavarini recovered funds from the primary CGL insurer, American Home Assurance Company, and paid these funds to the SDI insurer. But after receiving the limits under the American Home policy, Pavarini was still faced with more than $23 million in unreimbursed damages. Here, in order to satisfy its obligations to the SDI insurer, Pavarini sought reimbursement from the excess CGL policy carrier, ACE American Insurance Company (ACE). ACE steadfastly refused to pay out any amounts under the excess CGL policy. Accordingly, a lawsuit followed.

In the case styled *Pavarini Construction Co. (Se) Inc. v. ACE American Insurance Co.,* Case No. 14-CV-20524, Pavarini, for itself and for the SDI insurer, Steadfast Insurance Company, sued ACE in the United States District Court for the Southern District of Florida. Pavarini sought declaratory judgment "of the rights, duties and obligations under the ACE policy" and claimed that ACE was liable for monetary damages due to its breach of contract. The central issue in this case was whether ACE, as the excess CGL insurer, was ultimately responsible to reimburse the SDI insurer. Under the terms of the SDI policy, Pavarini had to fight this battle on behalf of the SDI insurer.

In an October 30, 2015 ruling, the federal district court judge presiding over the *Pavarini* case issued an order on the parties' motions for summary judgment. The court ruled in Pavarini's (and the SDI insurer's) favor on two key issues. First, the court found that Pavarini had standing to bring the lawsuit. ACE had challenged Pavarini's ability to even bring the lawsuit, arguing that Pavarini had been made whole by virtue of receiving payments from the SDI insurer. The court, however, disagreed, finding that Pavarini had "demonstrated invasion of its legally protected interest" in the SDI policy. In short, Pavarini was able to show the court that it had incurred significant expense based on its contractual obligations to the project owner as well as its contractual obligations to the SDI insurer, such that it could pursue claims for reimbursement of these damages against ACE.

Second, on the reimbursement question, ACE argued that the CGL policies and the SDI policy should combine to pro-rate the costs of the subcontractors' defective work. ACE based this argument on the CGL policies' so-called "other insurance" provisions. The court disagreed with ACE, reasoning that the CGL policies and the SDI policies did not address "the same subject matter, risk, and interest." The court supported this reasoning by finding that the ACE's CGL insured the project owner, Pavarini, and the covered subcontractors "against the risk of claims of property damage and bodily injury[,]" while the SDI policy insured Pavarini "against the risk of subcontractor contractual default." On this proration argument, the court ultimately concluded, however, that SDI policy should not have been reached ***first*** before the CGL policies to reimburse Pavarini for its costs to repair the defective work.

Although the *Pavarini* court recognized a key distinction between risks covered under CGL insurance and those covered under SDI, this decision leaves open the question of whether SDI should cover a subcontractor's defective work. Here, the court did not explore or explain what, if any, limitations should be placed on coverage for "subcontractor contractual default." Further, applying the court's reasoning, SDI could very well be extended to cover defective work if it is determined that the CGL carrier does not have a duty to offer such coverage or if the limits of the CGL policy (or policies) are less than the claimed damages.

Perhaps the key takeaway here for surety professionals and contractors is that with SDI the contractor-insured is contractually obligated to recover funds paid out under such policy. If any of the multiple insurers involved in a complex construction project, such as in the *Pavarini* case, seek to challenge responsibility for defective work, the burden and expense for contesting such determinations will likely fall on the contractor–leaving it potentially to devote significant unanticipated time and resources not reasonably related to delivering a construction project.

G. Scott Walters is an attorney in the Atlanta office of the law firm of Smith, Currie & Hancock LLP, where he serves clients in construction and real estate development. In his nearly 20-year career, Walters has represented owners, developers, sureties, contractors, and subcontractors and prosecuted and defended performance and payment bond claims for both private and public owners and contractors. He can be reached at gswalters@smithcurrie.com and 404.521.3800.

One Contractor's Transfer Preference: SUBCONTRACTOR BONDS

BY J. WILLIAM ERNSTROM

AN *ENGINEERING NEWS-RECORD* Top 13 contractor in 2015, Walsh Construction, one of the largest domestic heavy civil contractors, is a Chicago-based general contracting, construction management, and design-build firm and a long-time user of subcontractor bonds. In fact, Walsh requires every subcontractor whose subcontract price is $250,000 and over to be bonded. Walsh also requires subcontractors to provide the bonds equal to 100 percent of the individual subcontractor's contract amount. The bond must be written by a surety with a financial rating of AV or better.

Walsh's risk transfer preference is subcontract bonds rather than subcontractor default insurance (SDI) for a number of reasons:

- We like the fact that a respectable, financially viable surety, whose job it is to do the programmatic underwriting, is evaluating thoroughly the character, capacity, and capability of the subcontractor. A subcontract bond is not just a "one off" product.
- The bond coverage is for 100 percent of the entire scope of the subcontractor's work and is not a percentage of that scope. The standard SDI instrument has limits on the amount of coverage for any one subcontractor and may also have limits on the duration of subcontractor coverage.
- The bond covers the extra costs to complete the bonded subcontractor's work scope. There is no deductible feature on a bond nor is there any co-pay on a subcontractor's bond as there is with the SDI instruments. SDI instruments are catastrophic two-party insurance products.
- We can add a multiple obligee rider to the bond, so it covers both the owner and any lender involved in the project. There is no similar feature to the standard SDI product.
- We do a number of projects in the federal market segment. The SDI product is not as universally accepted in that market as are bonds.

Walsh does, however, make the subcontract bond more responsive, by modifying a standard bond form to conform to our company's preferences:

- We ask the subcontractor's surety to include the name and contact information for a specific claims person responsible for the particular account;
- We have included some other provisions to allow us to keep the project moving:
  - If the subcontractor requires financing to complete the project, we allow the surety to pay reasonable project completion costs, which will reduce the penal sum of the bond.
  - We require the surety to make a decision to complete its subcontractor's work scope in 15 days. The surety is entitled to a 50-day extension of that time frame by financing its principal during that time frame.

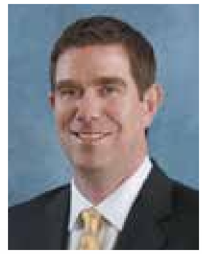
In short, Walsh views subcontractor bonds as a preferred means to address the risk of subcontractor default on its projects. Subcontract bonding has been a consistent policy of Walsh and will continue to be so well into the future.

J. William Ernstrom is Vice President for Major & Strategic Projects for Walsh Construction Company, one of the largest domestic construction services companies in the U.S. Ernstrom is one of the corporate leaders for Walsh on all large design-build, P3s, and project pursuits involving alternative project delivery systems. He is also responsible for the underwriting of all major projects pursued by Walsh. He can be reached at bernstrom@walshgroup.com or 312.563.5439.

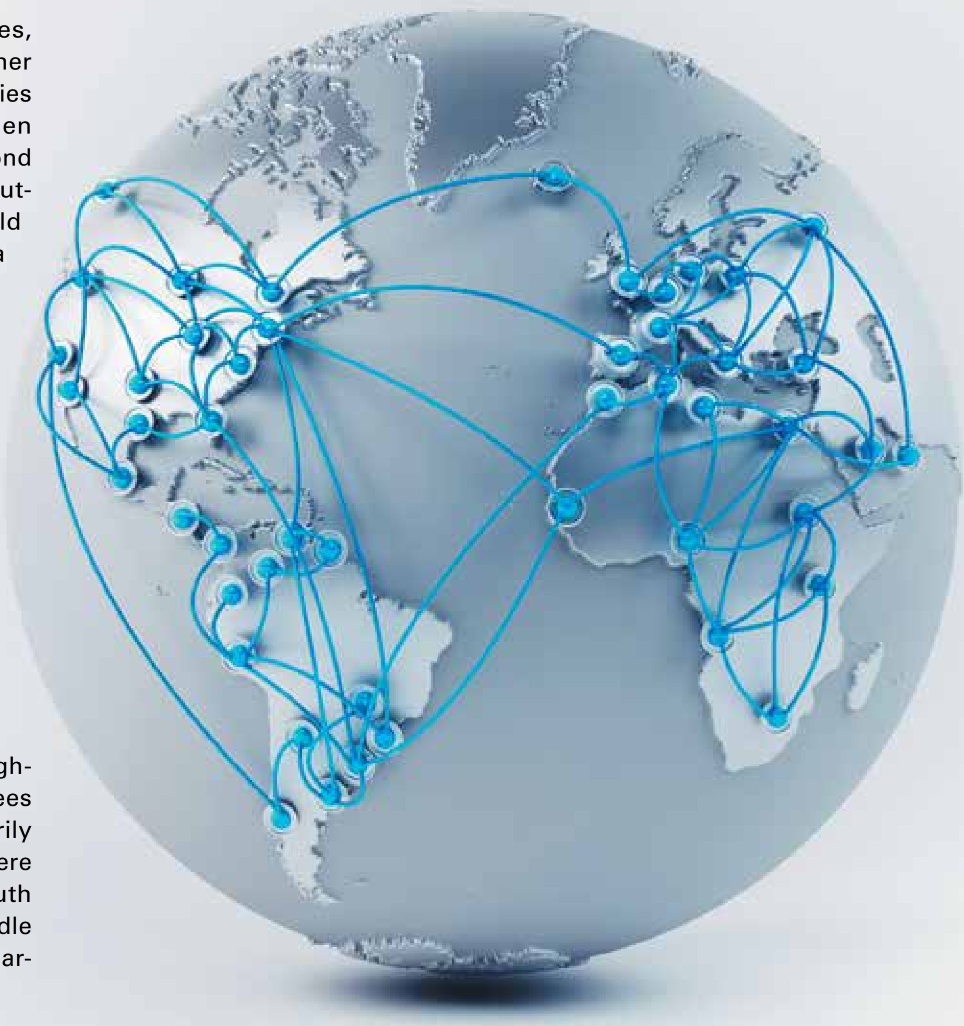
Feature

FACILITATING INTERNATIONAL Commercial Surety





BY HECTOR D. BOUSO   KATHLEEN MITCHELL   AARON T. ORT   CHRISTOPHER T. PARKER   SHEILA E. THOMPSON



AS THE GLOBAL economy changes, the need to provide bonds in another country for U.S.-domiciled companies will increase. What do you do when your biggest U.S. client needs a bond in another country? This article outlines some of the issues that should be considered when arranging for a bond to be written outside of the United States.

Where are the majority of international bonds written?
Latin America is one of the largest and most well-established surety bond markets outside of the U.S. Some of the largest markets include Mexico ($603 million in 2013), Brazil ($508 million), and Colombia ($473 million), according to a Swiss Re 2014 report, "Trade credit insurance & surety: taking stock after the financial crisis."

Surety bonds are also used throughout Europe although bank guarantees are used extensively. Asia is primarily a bank guarantee market although there are sizeable surety markets in South Korea and Japan. Africa and the Middle East are almost exclusively bank guarantee markets.

What are the most common types of international commercial bonds? Are international bonds typically regulated by underlying contracts or government regulations?

Performance bonds are the most common but, depending on the country, advance payment, customs, concession, tax payment, tax appeals, and other types of court bonds are used. Warranty bonds are also common in Latin America and issued along with performance guarantees.

Mexico uses a wide range of surety bonds that comes close to what we see in the U.S. In the Mexican surety market, as well as most of Latin America, bond forms are tightly controlled and written on prescribed forms. Many of these bonds are required by statute, and there is little or no deviation from the underwriting requirements and bond forms.

In most European countries, surety is a rather well-defined but narrow market where only a handful of statutory bonds, such as customs bonds, are written. Private contracts typically require letters of credit as opposed to a bond, and, if a bond is an option, it must be negotiated into the contract. These substitute bonds often look like a conditional letter of credit and typically are tailored to the contract.

What do producers need to know to support their clients' venture out of the U.S.?

Obtaining information up front before attempting a placement outside the U.S. is key to setting realistic expectations for what can be done and for satisfying your client. Some of the most important information needed includes:

a) Country the bond is to be filed in.
b) Time frame in which the bond is needed (5-10 days is a minimum turn-around, depending on country).
c) What is the obligation being guaranteed? Can this be guaranteed by another form of security, such as a letter of credit?
d) Are the underlying documents (bond form/contract) in English or is a translation needed?
e) Who is the bond beneficiary/obligee? Does the obligee routinely accept surety bonds or is this a new instrument?
f) The usual financial information, as would be required for a domestic case.
g) Previous experience with foreign bonds and management expertise outside of the U.S.

This information is critical to your ability to set proper expectations with your clients regarding their ability to get a bond in a particular country, the time needed to do so, and what additional information may be needed.

What does a producer need to know about indemnity required to support a foreign bond?

Many standard indemnity agreements now have language that covers bonds issued in foreign locales, whether through fronting companies or through the surety's own foreign subsidiaries. In some cases, however, riders or amendments to the indemnity agreement may be necessary. Further, indemnity from the foreign subsidiary of the customer, as bond principal, may be required, depending on the surety's standard practices or as a result of that foreign country's regulatory or legal environment.

There is an advantage to the surety in having "local indemnity" in order to manage disputes and mitigate losses, as the concepts and precedents in U.S. surety law may not be applicable in foreign jurisdictions. The options available to the surety in a foreign claim may be limited significantly without "local indemnity."

What are common practices for mitigating risk associated with the jurisdictional law?

Many underwriting companies have established country-specific indemnity agreements as a starting point in indemnity negotiations. That said, the involvement of experts, whether internal resources of the underwriting company or external counsel, is critical to a surety's efforts to mitigate risk. Who will bear these added costs should be part of any discussion relating to foreign indemnity.

Are bond amounts set at 100 percent of the contract or are they percentage bonds?

Percentage bonds are more common than 100% bonds; however, this does vary significantly. In Latin America 20% to 50% of the contract is fairly common, but typical supply contract and advance payment bonds are set at 100%. In Europe the percentages are lower (15–20%), but these bonds tend to be more like letters of credit and subject to unconditional demands by the obligee.

Will the U.S. surety market support clients that need only international bonds?

Most carriers prefer to write international obligations for principals where they have domestic business to offset the international risk. However, carriers will consider doing a one-off international bond, depending on the size and scope of the obligation, the country in which the bond is needed and the principal's financial metrics.

Correspondingly, the qualification requirements will vary depending on the nature of the obligation and country in which the bond is required. Carriers typically look for a working capital position of $30 million to $50 million before they consider international obligations.

Do international bonds have cancellation provisions in the bond form? Are bonds closed out at completion or are certificates of completion or other forms of releases required?

A lot depends on the type of bond, but, as a general rule, many foreign bonds require a release from the obligee. Cancellation provisions are more common in private contracts, but often, there are forfeiture requirements in the event the principal is unable to replace the bond. In countries such as Mexico, there are statutory requirements that a surety obtain a release and evidence that substantiates completion of the principal's obligation before a bond can be closed.

What triggers a bond claim in an international bond?

It is common to see "on demand" language in bonds issued outside of the U.S.—sometimes requiring the surety to pay within three business days. These clauses tend to be most common in bonds that require the surety to pay unconditionally in the event of a claim made against the bond. While there isn't a standard period of time that sureties will deem acceptable, it is rare to accept payment terms shorter than ten business days.

In summary, the international surety bond marketplace is both complex and growing; entrance into it should not to be undertaken lightly or quickly. The NASBP Commercial Surety and International Committees, composed of members and affiliates who are working in the international marketplace, can be a resource to help answer additional questions. ●

Members of the NASBP Commercial Surety Committee and the International Committee collaborated in writing this article. Hector D. Bouso, CPA, Vice President, Regional Underwriting Officer, Liberty Mutual Surety, can be reached at Hector.Bouso@LibertyMutual.com or 847.396.7166. Kathleen Mitchell, National Practice Leader, Surety, Wells Fargo Insurance Services, USA, can be reached at Kathleen.Mitchell@wellsfargo.com or 206.731.1204. Aaron T. Ort is Chief Underwriting Officer at Evergreen National Indemnity Company. Christopher T. Parker, Vice President and Chief Credit Officer, Chubb Surety, can be reached at cparker@chubb.com or 908.903.3736. Sheila E. Thompson, CIP, President, Rosenberg & Parker of Canada, Inc., can be reached at Sheila.Thompson@suretybond.com or 416.218.1280.

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bonding. One could argue that we are bifurcating our risk across both and taking the "easy" contractors and leaving the "more difficult" contractors for the sureties. This is not our position. We view surety bonds as an integral part of our risk management process. We would never consider managing risk on a project without the availability of surety bonds. It simply is impractical.

I am often asked by sureties what they can do to compete against SDI. I have a simple response. If you remove the perception that sureties are slow to respond to a claim under the remedies afforded by the bond, you are well on your way to healthy competition.

There is space for both in a robust risk management program. It's up to us as contractors to determine the level of financial commitment and risk we are willing to take for the reward. It is up to the surety industry to continually emphasize the value it brings to the contracting community by quickly responding when called upon and doing what sureties have done for decades, which is to provide confidence to the contractor purchasing the bonds that sureties have prequalified the subcontractor accordingly. ●

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