

Performance Bonds: Guaranteeing More Than You May Know

Lockton Construction Services | October 2007
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In the world of surety bonding, a constant tug-of-war exists between what owners and architects require in construction contracts and what the surety industry and their contractor clients are willing to provide.

As surety brokers, we spend a great deal of time educating our contractors on the appetite of the surety industry and how it affects their ability to bid and obtain bonded work. One topic we constantly address is long-term warranties, for which there exists a wide range of perception.

Many contractors believe a performance bond only guarantees their performance through completion of the work, while others

believe a bond will also cover any warranties 12 months following substantial completion. Very few contractors correctly understand that the performance bond actually guarantees all provisions of the contract, including all warranties. This fact alone does not present a problem; it is when the warranty period extends far into the future that sureties start to lose their nerve. Many of you already understand this, and have an appreciation for its significance. If not, I urge you to read on and discuss it with your surety broker and surety companies.

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Abbreviated “Bonds 101”

Before we dive into the topic of long-term warranties, let us first start with some bond basics used throughout the article. Surety bonds utilized on construction contracts are typically performance and payment bonds. Performance bonds protect the obligee (owner) of a project from financial loss upon the event of principal (contractor) default.

The labor and materials payment bond, or simply the payment bond, provides the obligee with assurance that any subcontractors, laborers, or material suppliers will be compensated to the terms described in any and all subcontracts. While payment bonds perform a very important risk-mitigating function, this article will focus on the performance bond and its maintenance/warranty aspect.

For the purposes of this article, we will use the term “warranty” exclusively. However, in the surety world, the terms “maintenance” and “warranty” are used interchangeably, both relating back to the contractor’s ongoing obligation to fix defective workmanship.

“Long-Term” Warranties Defined

Introduced above was the concept of extended or long-term warranties. What does the surety world consider “long-term”? As with all things surety, the answer is, “It depends!” The scope of work, geography of the work and credit worthiness of the principal are all determining factors in the length of warranty a surety will support. However, in theory, the premium you pay for performance and payment bonds includes an assumed one-year warranty obligation from the point of substantial completion on the bonded project. Therefore, the problem sureties have with extended warranties with any period of time beyond one year from substantial project completion or contractually triggered dates.

Also, a distinction must be made between manufacturer warranties and the warranty provided by the principal (contractor). To do so, one should evaluate what the contractor is solely responsible for and what can be

passed on to a manufacturer. Sometimes this distinction is very easy to make and sometimes it is not. For example, many roofing contracts require a specific brand of shingle that provides a 25 year or longer warranty. As long as the manufacturer supplying the shingle does not object to providing this warranty, the surety would likely view it as a “pass-through” warranty.

The same would apply for sealant applications. Many manufacturers of urethane and silicone sealants are so confident in their products that they have no hesitation in offering a ten- or even 20-year warranty, providing that proper testing and documentation are completed throughout the project. In most cases, these are intended as limited warranties (the contractor is liable for the first few years, and the manufacturer is 100 percent liable afterward). A problem arises when these warranties are specified as labor and material warranties, binding the manufacturer and the contractor to this time period.

Why Sureties Do Not Like Long-Term Warranties

To understand why sureties have such a difficult time with long-term obligations, we must first understand a key fundamental of the surety industry: surety credit is underwritten to a 0 percent expected loss ratio. Unlike insurance, where a portion of premiums provide for anticipated losses, the surety premium is simply an underwriting fee (generally passed through to the obligee) for the surety’s prequalification of the contractor. So in theory, if the underwriting and due diligence is performed properly, the sureties will not pay any losses due to contractor default. However, the surety industry experiences, as an annual average, loss ratios between 25 and 40 percent of their direct written premiums. Now, it is understandable why surety premiums are just a theory! Add on overhead and fixed costs upwards of 60 percent of direct written premiums and you are left with an industry operating on very slim profits, all the while undertaking substantial risk.





As the amount of time under a warranty provision increases beyond one year, it also becomes harder to determine whether the defects are chargeable to the contractor, inherent to the plans and specifications or are the result of some careless or even normal usage by the owner.¹

Reinsurance also plays a substantial role in the surety industry's ability to support extended warranties. Nearly all surety companies buy reinsurance to transfer a portion of their bonded risks. Reinsurance treaties govern the relationship between the surety and reinsurer, and often contain restrictions on long-term obligations. This can reduce a surety's ability to transfer risk, and as a result, the surety is much less inclined to support a long-term obligation.

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How the Warranty is Covered

Open any book on the subject of contract surety and you will find something similar to, “Performance

bond guarantees the faithful performance of a contract according to its terms and conditions.” This is accomplished by referencing and incorporating the contract on the performance bond form. For example: as the AIA A312, which is a very standard bond form, reads in Section 1, “The Contractor and the Surety, their heirs, executors, administrators, successors and assigns to the Owner for the performance of the Construction Contract, which is incorporated herein by reference.” Thus, a performance bond binds the surety by the same contractual terms and conditions to the obligee as the principal. Because of this, there are some key contract provisions that must be identified before a surety will provide a performance bond to a contractor. These include, but are not limited to: scope of work, duration of the work, default provisions, damages (liquidated, actual or consequential) and the warranty provision.

While it varies from contract to contract, many warranty provisions require the principal to warrant: 1) All materials and equipment incorporated into the work conform to the specifications, drawings and contract documents; 2) be first-quality, new materials free from defect in materials and workmanship; and 3) this warranty extends for a period of time that starts when the work is considered complete. If, at some point during the warranty period, one of the provisions would be triggered, the contractor is often required to remedy the defective material/workmanship at no cost to the owner. This constitutes a performance obligation to the contractor, and therefore, possibly to a surety as well through a performance bond. Depending on the contract, this obligation can be either easy to quantify, or very vague.

When long-term warranties are passed down through subcontracts by the use of ambiguous language, quantifying this obligation becomes difficult. It is not uncommon for a subcontract warranty provision to read, "...contractor is bound by the same warranty required in the prime contract." In this situation, a copy of the prime contract must be obtained to accurately determine the warranty being guaranteed by the performance bond.

Examples

1) *The Tudor Development Group, Inc. v. United States Fidelity & Guaranty Co.*²

This case is a perfect example to highlight the scenario of the contract prevailing over the language of the bond. The plaintiffs brought action against USF&G, alleging its contractor's performance, under the warranty provision in the construction contract, was deficient. In its motion to dismiss, USF&G argued the performance bond did not provide coverage for breach of warranties since it was not included in the text of the bond. The district court disagreed with USF&G's argument, pointing to the fact that the bond expressly incorporated the construction contract. This meant the surety's obligations were only discharged when the contractor had "promptly and faithfully" performed under the contract. The motion to dismiss was denied.

2) *J.B. Mouton & Sons, Inc., Plaintiff v. Alumawall, Inc., and Great American Insurance Company, Defendant*³

This case highlights the possibility of jurisdictional statute prevailing over the bond form. In this case, Alumawall entered into three subcontracts with Mouton for glass and glazing work to be performed on three separate buildings. Mouton required Alumawall to provide three performance bonds guaranteeing the performance on the subcontracts. Two of the bond forms contained language limiting the time frame a claim could be made to 12 months after completion of the work. However, these bonds also contained the following clause, "...but if there is any maintenance or guarantee period provided in the contract for which





said Surety is liable, and action for maintenance may be brought within six months from the expiration of the maintenance period, but not afterward.” The bond form for the third subcontract only contained the following, “Any suit under this bond must be instituted before expiration of two years from date on which final payment under the subcontract falls due.”

Mouton did not file suit until five years after final payment was made on each subcontract. Once again, each subcontract was incorporated into the bond form by reference. Each contract’s warranty section referenced, “as may be applicable by law” to provide the warranty’s duration. At the time, Louisiana law provided a ten-year implied warranty of fitness for building construction contracts. Therefore, because the first two bonds expanded coverage by referencing, “...any maintenance or guarantee period provided in the contract,” and the warranty section referenced “as may be applicable by law,” the court ruled the bonds were valid and enforceable until six months beyond the expiration of the ten-year statutory warranty period. However, because the third bond provided a specific and unambiguous limitation on its enforceability, the court upheld the two-year period.

3) *The AIA A312 Bond Form*

The AIA A312 bond form, a form widely used throughout the surety industry, provides any jurisdiction’s statutes the right to prevail over the bond. Specifically, Section 11 reads:

When this Bond has been furnished to comply with a statutory or other legal requirement in the location where the construction was to be performed, any provision in this Bond conflicting with said statutory or legal requirement shall be deemed deleted herefrom and provisions conforming to such statutory or other legal requirement shall be deemed incorporated herein. The intent is that this Bond shall be construed as a statutory bond and not as a common law bond.⁴

What do these examples amplify? In determining exactly how the warranty is covered and also what is covered, we must be careful on three fronts. First, we must be well aware of the obligations within the contract. Secondly, we must be cognoscente of how our local jurisdictions view these matters. And lastly, we also should be familiar with the bond forms we are signing and how they react to certain contractual and statutory conditions.

Why All This Matters

You may be asking yourself, “Why should I care? How does this impact me as a contractor?” First and foremost, the relationship between a surety and a contractor is built on trust. Sureties often do not see a copy of the contract they have bonded until after the performance bond is executed and is in force. If a surety is not able to trust the accuracy of the information provided by its client, the relationship will not last.

Before any company, person or entity can obtain a bond, it must provide an indemnity package to the surety. This is required because, as discussed above, the surety underwrites to a 0 percent loss ratio. The surety would look to the indemnity package to provide loss-paying power in any claim situation. In the construction industry, the typical indemnity package comprises of both corporate and personal indemnity.

The document governing the terms and conditions of this indemnity is known as a General Indemnity Agreement, or GIA. Each surety has its own GIA form, but by and large they contain similar provisions. If you have ever reviewed a GIA, or better yet, been asked to sign a GIA, you know describing it as “onerous” may be an understatement. It is unfortunate the GIA has to be written with so many teeth, but the surety has to be able to protect itself in the worst possible scenarios. One of the key terms standard on most GIAs is the surety’s ability to settle claims unilaterally, meaning, the surety can investigate and settle a claim with an obligee without its client’s input. This is absolutely not the way sureties prefer to handle claims, but they must retain the ability to do so.



From ownership to field crews, all parties should understand the significance of indemnity as it relates to performance bonds. For owners personally indemnifying, the significance is magnified. Take the J.B. Mouton & Sons case from above; apply what you now know about indemnity, and imagine yourself in that position. Remember, if the surety has a problem, you have a problem.

Summary

So, how do we start to bridge the gap between the sureties and the owners/architects on the topic of long-term warranties? The answer is two-fold. First, as an industry, waterproofers must come to the understanding that performance bonds, barring any limiting factors, guarantee all warranties contained within bonded contracts. Second, waterproofers must work with owners/architects to come up with solutions that are amenable to all parties. Frank Halsey, President of Mid-Continental Restoration, sums it up well:

“As waterproofers, we are the frontline representatives of our surety partners to the owners and architects pushing for long-term warranties. There are ways to provide

the warranty they desire without taking the sureties out of their comfort zone. For instance, limiting the time frame of the surety’s obligation does not remove the contractor’s warranty responsibility. Sometimes the solution can be that simple, but until we come together as an industry on this issue, nothing will be accomplished.”⁵

- 1 Remmen, Albert. *The Contract Bond*. Cincinnati: A National Underwriter Publication, 1977.
- 2 Tudor Development Group, Inc., Sidney Cohen, Dorothy Cohen, Marc Cohen, t/a Green Hill Associates, Plaintiffs, v. United States Fidelity & Guaranty Company, Defendant. No.88-0758. United States District Court for the Middle District of Pennsylvania. 25 Aug. 1988.
- 3 J.B. Mouton & Sons, Inc., Plaintiff- Appellant v. Alumawall, Inc., Defendant and Great American Insurance Company, Defendant- Appellee. No.90-191. Court of Appeal of Louisiana, Third Circuit. 16 July 1991.
- 4 American Institute of Architects Performance Bond. Pub. L. AIA Document A312. Mar 1987.
- 5 Halsey, J. Frank. Mid-Continental Restoration Co., Inc, President.

This article appeared in the Summer 2007 edition of the *Applicator*, the publication of the Sealant Waterproofing & Restoration Institute.

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