

CONSTRUCTION PERFORMANCE BONDS AND CLAIMS:

OVERVIEW OF PERFORMANCE BONDS AND CONTRAST WITH LIABILITY INSURANCE

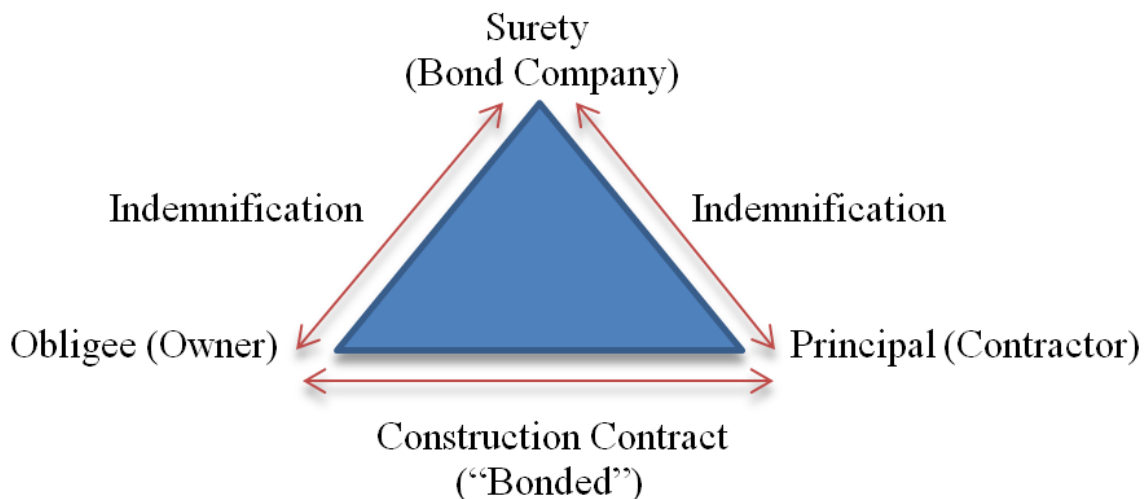
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Contractors on both sides of performance disputes ask for us guidance on performance bonds and clarification between performance bonds and liability insurance. In those discussions, I've noticed that lack of clarity comes from trying to view a performance bond through the lens of the relationship between an insurance company and its insured. However, the structure of the bonding relationship and bond claim process is quite different. Stepping out of the insurance mindset is the best place to start in understanding a construction performance bond.

Who are the Players?

A typical performance bonding scenario has the following structure:





The construction company being bonded (the “**Principal**”) has paid for the bonding company (the “**Surety**”) to agree that if the construction contractor (Principal) fails to perform its obligations under the construction contract with the owner (the “**Obligee**”), then the Surety will pay the owner (Obligee) or otherwise step into the project.

What about subcontractors? The arrangement between the performance bond players is similar to the above, but rearranged slightly in government construction projects or large private construction projects where subcontractors (as Principal) are also bonded for their performance of on a subcontract with the general contractor (as Obligee).

What Type of an Agreement is a Construction Performance Bond?

The Surety’s obligation is neither a guarantee of performance nor insurance. The bond is a financial agreement—a contract—of indemnity that the construction contractor or subcontractor will provide work, labor, materials, and equipment in conformance with the project’s contract documents. The bond covers the work of the contract and typically no more. For example, the language of the AIA A312 §9 provides,

The Surety shall not be liable to the Owner or others for obligations of the Contractor that are unrelated to the Construction Contract....

The value or cap on the construction performance bond (the “**Penal Sum**”) is generally fixed at the value of the original construction contract being bonded. The performance bond’s coverage for change orders will be dictated by the bond’s terms. The terms of the bond, like any other contract, control. In public projects state and federal law and regulation also direct the bond’s terms and the parties’ relationships.

What About Performance Bond Claims?

Construction performance bond claims can be made during construction (failure to perform) or after (defective work, warranty claims, or call-back periods). When performance issues arise on the project, an analysis with your legal and contracting team should be undertaken to evaluate the need or opportunity to make a bond claim. Whether or not the contractor is in default, situations where a lower tier supplier or subcontractor has claimed default, or other situations where the Surety’s involvement may be advantageous, are often triggering events for a potential performance bond claim. From the Surety’s perspective, each claim that comes in will be scrutinized for whether it triggers the Surety’s duties, starting with any duties of the Surety to investigate the claim itself.

Is a Construction Performance Bond Another Form of CGL Insurance?

No. Commercial General Liability (CGL) policies generally do not cover a construction contractor’s work on the project itself (with the exception of Builder’s Risk Insurance).



Rather, insurance covers incidents causing injuries to persons or damage to property other than the contractor's work product. Once a claim is paid, unlike a Surety, the insurance company does not seek reimbursement from the construction contractor for monies it pays out on a claim, though the contractor's premiums for continued or renewal coverage may go up.

The cycle of looking to someone else for payment in the bonding context does not end with the Surety. The Surety will look to the Principal (the construction contractor being bonded) for reimbursement of any amounts the Surety pays out to the Obligee. This part of the arraignment is generally governed by a separate indemnity agreement between the bonding company and the contractor.

ABOUT THE AUTHOR:

Reed F. Morris is a Denver-based attorney who regularly represents owners, contractors and sureties in payment and performance related construction litigation including bond claims, mechanic's liens and related disputes. He is a partner at MLMW and represents parties to construction disputes in state and federal courts and all alternative dispute venues including mediations and arbitrations (AAA). Reed can be reached for questions at rmorris@mlmw-law.com or by phone at (303) 927-0011 (direct).



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