feature

Issues with Automatic Increases to the Bond Penalty

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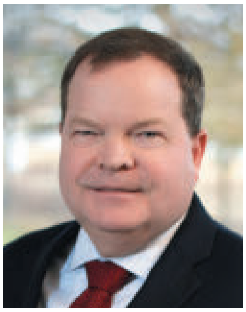

BY DAN POPE

THERE ARE A number of large general contractors whose subcontracts and bond forms provide for an automatic escalation in the bond penalty with every increase in the subcontract price *without* consent of surety. Normally within these subcontracts and bond forms there is an upper limit to how much the contract price can increase, after which a consent of surety is required to increase the bond penalty. But it is uncomfortably high: 20% to 30% in many cases.

When you read every performance bond form, you will see that the surety waives notice of change to the contract. In one respect this is a practical administrative reality. If the surety required notice and required consent for each and every change to every contract, the surety would be buried in correspondence. Often, changes are very small adjustments to the contract to clarify a specification or a term that does not materially change the risk. In other respects, this same waiver of notice could result in a substantial increase in risk, which the surety may not want to take. The surety bears the burden of keeping itself informed of material changes to the bonded contract through its underwriting relationship with the bond principal. That is one of the many reasons sureties require work-in-process schedules (WIPs) from standard accounts.

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The Surety's View

However, increasing the contract price is not the same thing as increasing the bond penalty. Increasing the contract price increases the surety's exposure to a possible loss. In and of itself, a contract price increase does not increase the dollar value of a surety's total possible loss, due to the limitation of the surety's exposure being fixed to the penal sum limit of the bond. This begets a bit of confusion with bond principals, agents, and obligees alike, especially when the surety bills for the increase in contract price without increasing the bond penalty.

For the sake of keeping the numbers simple, consider a $1 million bond on a very simple $1 million contract to pave 10 miles of road. The road is straight, level, and has no bridges; therefore, each mile of paving costs the same as the next mile: $100,000. While the contractor is paving the first mile of road, the obligee requests that the contractor pave an additional five miles of equally uninteresting road under the same contract for the same price, $100,000 per mile. The contractor agrees. The change is made to increase the contract price to $1.5 million.

No one tells the surety. The effect is that the bond penalty remains $1 million. However, now, instead of having 10 miles of road where something could go wrong and cause a claim, we have 15 miles of road where something could go wrong and cause a claim. The maximum the surety would be obligated to pay remains $1 million. But now the risk of that claim is greater due to the additional five miles of road; therefore, the surety is entitled to bill for the increase in contract price because the possibility of a claim is greater—50% greater. The surety is entitled to charge for the increased possibility of loss, either when we are made aware of the increase in contract price on the next WIP received or when the job is finished and the bond is closed out.

That is the perspective of the surety. Now, put yourself in the shoes of the obligee.

THE SURETY IS ENTITLED TO CHARGE FOR THE INCREASED POSSIBILITY OF LOSS, EITHER WHEN WE ARE MADE AWARE OF THE INCREASE IN CONTRACT PRICE ON THE NEXT WIP RECEIVED OR WHEN THE JOB IS FINISHED AND THE BOND IS CLOSED OUT.

What the Obligee Perceives

The contractor will pass on the additional bond cost to the obligee as part of the agreement to take on the additional scope of work. The obligee sees the additional bond cost and wonders why she is paying more but the bond penalty remains the same. It seems unfair.

To counter this perceived inequity, the obligee requests that the bond penalty be increased. Truly there is no issue with this. The surety has the exposure one way or the other. It does increase the maximum possible loss under the bond. But full bond penalty losses are not the norm.

Why Sureties Push Back

So why is it an issue for sureties when large general contractors require automatic increases to the bond penalty without consent of surety? Simply put, the surety must be able to accurately track and manage its ultimate exposure to any given bond principal. Due to the waiver of notice in the bond form, under these bond forms, the penalty could increase 30% without a whisper to the surety. That is a lot of additional risk exposure to not be reported and taken into consideration when managing a surety account.

Accordingly, the surety would far prefer that the obligee request its consent to increase the bond penalty so that the surety can manage the underwriting approach to the account. The consent requirement gives the surety real time notice of the increase in exposure rather than waiting around for the next WIP to arrive or to find out about the increased contract price at the end of the job when it closes out.

Sureties generally want to push back on these automatic increase clauses. It is not unreasonable to require consent of surety to increase the bond penalty.

The obligee may consider this cumbersome. Although it could take a day or two, it is not impractical. In this day of smart phones, fillable PDFs, and email, things happen fast. Rarely is a postage stamp and a trip to the post office required these days.

If the general contractor is intractable on the issue of striking automatic increase clauses in the bond form, plan B is to get the threshold for the consent of surety lowered to a more comfortable level, say 10% or even 15%, which are much more acceptable than 30%.

Plan C is to look at the overall subcontract and decide whether or not to accept the risk of escalation. If the subcontract price is small to begin with, or the nature of the work is uncomplicated, and the bond principal is adequately capitalized perhaps the underwriter will only raise the issue with the account so the contractor may understand the additional risk and price it accordingly in her bid. However, if the subcontractor is not well capitalized or her bonded backlog is approaching the limit of the subcontractor's surety credit capacity, inflexibility on the part of the general contractor to modify the bond form may lead to the declination of the bond request by the surety.

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