Performance/payment bond claims may rise due to contractor defaults caused by lack of new work

August 24, 2009 - Long Island

In a good economy, claims against performance and payment bonds can be minimized because the contractors who must personally indemnify the surety company will risk using funds from one project to fund one that is having cash flow difficulties. However, what happens when fewer or, in some cases, no projects are being let by private developers or governmental agencies? The answer is that there will be a rise in defaults by contractors and claims against payment and performance bonds.

Contractors who rely on the cash flow from profitable projects to support unprofitable projects will not have that constant stream of revenue to rely upon. That leaves contractors with two choices. One is to put up equity to financially support unprofitable contracts, and the second is to default on contracts. If the general contractor decides to infuse capital into a money losing contract, then the chance of a claim arising against a performance or payment bond is significantly reduced. However, when the general contractor decides to use funds from one project to cover costs on another, or simply abandon a project, claims against payment bonds will start to mount. At first, when a general contractor starts using funds from one project to cover the costs of another, a contractor may be able to "catch up" with its current financial obligations since there are usually more profitable contracts ongoing than unprofitable ones. However, when there is a severe lack of new projects to generate positive cash flow, there is a high probability that the contractor will end up without enough cash to pay all costs on a much greater scale. At that point, the general contractor will not be able to pay its subcontractors on those projects where the contractor took the money to pay the costs of the previous contracts. Once that contractor fails to pay subcontractors, the subcontractors, faced with limitations periods set forth in State statutes and/or in the bonds themselves to send notices of claim to the sureties and commence actions against the bonds, will begin to send out notices of claim and commence actions against the bonds to preserve their rights.

Another type of claim that surety companies must also be careful of are those brought by union fringe benefit funds for non-payment by contractors and their subcontractors for fringe benefits due for labor provided to the project. Pursuant to collective bargaining agreements between employer-contractors and employer-subcontractors, for each hour worked by a worker, the contractor has to remit the corresponding hourly fringe benefit to the union fringe benefit funds for each hour worked. When there is a lack of cash flow, contractors and subcontractors tend to pay union fringe benefits last or do not pay them at all and simply go out of business. Pursuant to case law in many jurisdictions, the union fringe benefit funds have a claim against the payment bond for fringe benefits. In those instances, the surety is often faced with a contractor or subcontractor who has closed up shop and disappeared. Making matters worse for the surety, in the case of a subcontractor, the surety may be held liable for the fringe benefits (and wages too) despite the fact that the general contractor paid the subcontractor all amounts due under the subcontract.

In addition to the claims by subcontractors, owners will be faced with the abandonment of contracts by general contractors. Without the cash from the next project to pay the subcontractors on other ongoing projects, the subcontractors will stop performing their work which will cause the general contractor to breach its contract with the owner. The general contractor will leave the owner with an incomplete project and claims by subcontractors despite the fact that the owner has paid the general contractor the funds which should have been paid over to the subcontractors. This will bring a rise in claims against performance bonds, the amounts of which generally can be greater than the payment bond claims combined depending on the value of the contract.

In sum, surety companies should be prepared for a significant rise in claims and must be extra careful in this economy in making sure that each person or company performing work at the project is getting paid. While it is easier said than done, sureties must take extra precautions in policing payments in order to minimize claims.

Andrew Richards, Esq., is a partner with Kaufman Dolowich Voluck & Gonzo, Woodbury, N.Y.