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Northeast Surety & Fidelity Claims Conference

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**SEVENTEENTH ANNUAL
NORTHEAST SURETY AND FIDELITY
CLAIMS CONFERENCE**

SEPTEMBER 21st and 22nd, 2006

**ISSUES AND PRACTICAL CONSIDERATIONS FOR THE
SURETY IN USING SUBCONTRACTOR RATIFICATION
AGREEMENTS**

PRESENTED BY:

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I. Introduction

Where a contractor/principal is subject to a default termination and the surety decides to facilitate the completion of the bonded project (“the terminated project”), it may be advantageous to the surety to have one or more of its principal’s subcontractors (“the original subcontractors”) complete the work within the scope of their original subcontracts under the prices, terms and conditions of those subcontracts. The advantages may include the following:

- Price. The subcontract price of the original subcontract may be less than the price that could currently be negotiated on the open market. This could reflect numerous factors, including: a change in market conditions given the passage of time since the original subcontract was negotiated; greater knowledge regarding the complexities or problems associated with the job or the job’s reputation in the subcontractor community; the risks associated with having to complete another company’s work; or the perception in the subcontractor community that the pressures on a surety facing a “terminated project” would compel the surety to accept an above-market subcontract price with an above-market profit margin.
- Availability. The original subcontractors may have their equipment on the job site and should already have factored the completion date for the project into their work schedules.
- Promptness. The original subcontractors could presumably re-start their work immediately with no need for substantial mobilization or planning. Contracts with vendors would often be in place. In contrast, a new subcontractor would need to fit a completion project into its schedule, mobilize, and purchase materials that may have long lead times.
- Knowledge. The original subcontractor’s knowledge of the job may translate into cost-savings, greater speed, or fewer unanticipated problems once the completion work had begun.

- Unique Skills. There may be no other subcontractor in the area that has the skills necessary to complete the work.
- Defective Work. The original subcontractor has an incentive to address its own pre-existing defective work in a cost-effective and time efficient fashion. A new subcontractor may have contrary interests depending on the terms of its subcontract.
- Warranties and Guaranties. Continuity in the trade should minimize issues regarding the effectiveness of manufacturer's and trade warranties. The hiring of a new subcontractor may jeopardize or complicate warranty and guarantee issues.
- Claims. To the extent that there are unresolved change order issues or the principal has claims to assert against the owner, the continued involvement of the original subcontractors may assist in the most favorable resolution of these issues given the original subcontractor's knowledge base and possibly its financial interest in the outcome.

In many cases, one or more of the original subcontractors may take the position that the principal's termination by the owner terminates the subcontractor's remaining obligations under its original subcontract or that, in the face of a termination of the contractor, the subcontract allows the subcontractor to terminate the subcontract unless the contractor's termination is remedied within a reasonable period of time.¹

Where a surety facing a terminated project determines that it will participate in the completion of the project and that it would be advantageous for one or more of the original subcontractors to complete their work under their original subcontracts, the available mechanisms for returning the original subcontractors to the project will likely include the following or some variation of the following:

¹ See Carolina Casualty Insurance Co. v. Ragan Mechanical Contractors, 584 S.E.2d 646 (Ga.Ct.App. 2003). Compare Employers Insurance of Wassau v. Bright Metal Specialties, 251 F.3d 1316 (11th Cir. 2001).

- Facilitating the direct assignment of the original subcontractor's subcontract from the principal to a party that would be responsible for completion;
- Entering into a ratification agreement with the original subcontractor under which, inter alia, the subcontractor would ratify the original subcontract and agree to complete its work according to its terms in exchange for payments made by the surety for sums allegedly owed to the original subcontractor and possibly other concessions; or
- Facilitating the efforts of the obligee or a completion manager or contractor to negotiate an entirely new agreement with the Original Subcontractor.

Alternatively, if a cooperative principal has not yet been terminated, it may be possible to have the principal assign the bonded contract to a completion contractor or convince the obligee to rescind a termination in order to facilitate an assignment.

The methodology best suited in a given context for returning the original subcontractor to the project will depend on numerous considerations, including the arrangement that the surety enters into with the obligee by which the surety participates in the completion of the Project. Depending on the terms of the bond and the positions of the owner, the surety's completion options may include the following or variations of the following:

- Entering into a take over agreement with the obligee and contracting with a new completion contractor/manager for the completion of the work;
- Entering into a tender agreement with the obligee under which the surety tenders a new contractor and pays some or all of the difference between the bonded contract balance and the new contractor's completion price, if any;
- Buying out its exposure by making a cash payment to the obligee in exchange for a release of the performance bond obligation; or

- Proposing the return of the principal to the Project through a tender or through a take over and completion contract with the principal, with possible financing of the principal, where appropriate.²

Once the surety identifies the likely completion options, it can make a more reasoned decision regarding the mechanism for returning an original subcontractor to the project, though this decision will still be colored by numerous fact specific variables.

This paper will address the legal and practical considerations that bear on a surety's decision regarding the mechanism by which it attempts to bind original subcontractors to complete their work on a terminated project. The primary focus of the analysis will address the advantages and disadvantages of ratification agreements and issues relating to the drafting and content of such agreements, though alternative options will be discussed as well.

II. **Assignments of Subcontracts**

In the event of a default termination of the principal, there may be three methods of assignment by which an initial subcontract remains binding on the initial subcontractor.

A. *The Assignment Clause of the Indemnity Agreement*

Most Indemnity Agreements include an Assignment Clause with language much like the following:

The Contractor, the Indemnitors hereby consenting, will assign, transfer and set over, and does hereby assign, transfer and set over to the Surety, as collateral, to secure the obligations in any and all of the paragraphs of this Agreement and any other indebtedness and liabilities of the Contractor to the Surety, whether heretofore or hereafter incurred, the assignment in the case of each contract to become effective as of the date of the bond covering that contract, but only in the event of: (1) any abandonment, forfeiture or breach of any contracts referred to in the Bond or of any breaches of any said Bonds; or (2) of any breach of the provisions of any of the paragraphs of this Agreement;...(a) All of the rights of the Contractor in and growing in any manner out of all contracts referred to in the Bonds; (b) All of the rights, title, and

² If the surety is able to convince the owner to rescind the principal's termination, issues regarding the continued operative effect of the original subcontracts should, in most cases, be obviated.

interest of the Contractor in and to all machinery, equipment, plant, tools, and materials which are now or may hereafter be, about or upon the site or sites of any or all of the contractual work referred to in the Bonds or elsewhere, including materials purchased for or chargeable to any and all contracts referred to in the Bonds, materials which may be in process of construction, in storage elsewhere, or in transportation to any and all of said sites; (c) All the rights, title and interest of the Contractor in and to all subcontracts let or to be let in connection with any and all contracts referred to in the Bonds, and in and to all surety bonds supporting such subcontracts....³

As discussed below, many construction subcontracts include language that would bind the subcontractor to an assignment of the subcontract. In the absence of such language and in the absence of an express contract provision prohibiting an assignment, an executory bilateral contract which does not involve personal skill, trust, or confidence is generally assignable in the absence of consent from the other party so long as the assignment does not materially alter the responsibilities and duties of the contracting party.⁴ As a construction contract is generally not deemed to be a personal services contract, a surety exercising the Assignment Clause of an Indemnity Agreement should be able to take a valid assignment of one or more of its principal's subcontracts regardless whether the subcontractor consents to the assignment.

The primary advantage of exercising rights under an Assignment Clause is that this may bind the original subcontractor to complete its work on the project under the terms specified in its original subcontract with no legal right to re-negotiate those terms.

The practical problems or drawbacks in invoking the Assignment Clause include the following:

- Generally, an assignee assumes the rights and obligations of the assignor, including the assignor's liabilities under the assigned contract.⁵ Therefore, the surety's exercise of its

³This language is derived from a model agreement drafted in 1965 by a subcommittee of the Claims Advisory Committee of the Surety Association of America.

⁴ See Smith v. Cumberland Group, 687 A.2d 1167 (Pa. Super. 1997); Restatement Second of Contracts §§ 317, 318.

⁵ Restatement Second of Contracts, §335. See Kunzman v. Thorsen, 740 P.2d 754 (Or. 1987).

assignment rights might subject it to exposure to all of the subcontractor's claims against the contractor which arise under the subcontract. These could include claims for lost profits or other consequential damages which would not be compensable under the payment bond. At a minimum, if the surety exercised an assignment of one of the original subcontracts, it could be exposed to reasonable demobilization and mobilization costs and would likely be exposed to delay damages, including unabsorbed home office overhead and extended field conditions, from the time of the contractor's termination until the date that construction resumed.⁶

- In order to avoid subjecting a subcontractor to an indefinite period of uncertainty, a court would likely read into the Assignment Clause a reasonable time period subsequent to the principal's termination after which the subcontract would be deemed to be in breach and the rights afforded under the Assignment Clause would be deemed to have expired. It is difficult to imagine that the period would be greater than 90 days. Whatever a safe period of time within which a surety could weigh the option of asserting its assignment rights, the time allowable may not be sufficient to allow the surety to conduct a reasonable investigation of all pertinent factors, including, but not limited to, whether the contractor's termination was lawful, whether it was advisable to assist the owner in the completion of the project and, if so, through what kind of contractual arrangement, whether the construction company completing the project would accept a further assignment of the subcontract that the surety contemplated assuming, the quality of the subcontractor's work,

⁶ This concern, while always of significance, may be somewhat of a lesser magnitude to the extent that courts have extended the range of exposures under public works payment bonds. Compare D&P Corp. v. Transamerica Insurance Co., 881 F.Supp. 1505 (D.Kan.1995) (surety liable under Miller Act payment bond for delay damages and lost profits) and Mai Steel Service, Inc. v. Blake Construction Co., 981 F.2d 414 (9th Cir. 1992) (surety liable under Miller Act payment bond for delay damages caused by the owner) with Consolidated Electrical & Mechanical, Inc. v. Biggs General Contracting, Inc., 167 F.3d 432 (8th Cir. 1999) (Miller Act surety is not liable for lost profits).

and the extent of the additional exposures to which the surety would be exposed if it accepted the assignment of a particular subcontract.

For the foregoing reasons, the exercise of the rights afforded under the Assignment Clause may not be practical or desirable. Nonetheless, there are circumstances under which the exercise of these rights may be practical and cost effective. Consider the following scenarios:

- Assume a situation where the principal is unable to commence work on a Project due to its own internal financial problems or abandons a job soon after commencing work due to its financial problems. The surety may decide to tender a contractor as a means of satisfying its performance bond obligation and it may be able to do so with reasonable promptness. The surety's exercise of its assignment rights in relation to certain key original subcontracts may make it possible for a new contractor to more quickly submit a price and to submit a lower price than if the contractor needed to solicit new subcontract bids. The assertion of the assignment right may preclude an original subcontractor from choosing not to work for the new contractor or from attempting to re-negotiate its subcontract with a new contractor. At a minimum, the assertion of an assignment may provide leverage in any negotiations with the original subcontractor. Assuming that the principal's work on the job had not commenced or had hardly commenced, the surety's risk of financial exposure to claims outside of the scope of the payment bond might be minimal and a reasonable risk to assume given the possible benefits of an assignment.
- Assume that a solvent and competent principal is terminated on a bonded project. As a means of addressing a performance bond claim, the surety may decide to tender its principal to the owner or take over the project and use its principal as the completion contractor. Alternatively, the principal may have its own suggestions for completing the work that may involve the intervention of another construction company selected by the principal. The principal may also be able to hold the surety harmless financially from any

additional exposures that could result from the surety exercising assignments over one or more of the original subcontracts. If, under this fact pattern, certain subcontractors would be reluctant to return to the project or would be inclined to do so only if they could re-negotiate their subcontracts with the principal, the assertion of an assignment might facilitate their return to the project under either the terms of the original subcontract or terms close to those of the original subcontract with little or no risk of added exposure to the surety.

- Assume that a competent principal is terminated on a bonded project solely due to cash flow or other financial problems. Assuming that the surety is prepared to finance the principal and that the owner is not prepared to revoke the termination, the surety may be able to decide within a short period after the termination to tender its principal to the owner or take over the project and use its principal as the completion contractor. The cooperating principal may be able to demonstrate to the surety that there were few if any exposures to subcontractors beyond those covered under the payment bond. If, under this scenario, certain subcontractors would be reluctant to return to the project or would be inclined to do so only if they could re-negotiate their subcontracts with the principal, the assertion of an assignment might facilitate their return to the project under either the terms of the original subcontract or terms close to those of the original subcontract with little or no risk of added exposure to the surety.

Extrapolating from these hypotheticals, it is possible to generalize that exercising assignment rights under the Assignment Clause may be an attractive option in circumstances which evidence some combination of the following characteristics: the termination occurs early in the project; the surety's investigation can be quickly completed; the principal is competent and willing to complete the project and is either solvent or a suitable candidate for financing; a completion proposal, either involving the principal or a new construction company, can be

formulated relatively quickly; and the principal's exposures to its subcontractors which are beyond the scope of the payment bond obligation can be identified quickly and or manageable under the circumstances. Under certain combinations of these characteristics, the prompt exercise of the assignment rights under the Assignment Clause may either convince a recalcitrant subcontractor to return to the project under the terms of the original subcontract or may provide significant leverage in the course of re-negotiating the terms of the original subcontract and other claims issues.

B. The Assignment Provisions of the Subcontract and the Prime Contract

Many subcontracts and contract forms include complementary provisions under which the owner has the right to take by assignment one or more of the contractor's subcontracts in the event that the contractor is terminated.

The following provisions from the AIA forms A401 and A 201, 1987 edition, and A401 and A201, 1997 edition, are illustrative.

1987 EDITION

A401 (subcontract form)

7.3 ASSIGNMENT OF THE SUBCONTRACT

7.3.1 In the event of termination of the Prime Contract by the Owner, the Contractor may assign this Subcontract to the Owner, with the Owner's agreement, subject to the provisions of the Prime Contract and to the prior rights of the surety, if any, obligated under bonds related to the Prime Contract. If the work of the Prime Contract has been suspended for more than 30 days, the Subcontractor's compensation shall be equitably adjusted.

A201 (prime contract- general conditions)

5.4 CONTINGENT ASSIGNMENT OF SUBCONTRACTS

5.4.1. Each subcontract agreement for a portion of the Work is assigned by the Contractor to the Owner provided that:

- .1 assignment is effective only after termination of the Contract by the Owner for cause pursuant to Paragraph 14.2 and only for those subcontracting agreements which the Owner accepts by notifying the Subcontractor in writing; and

- .2 assignment is subject to the prior rights of the surety, if any, obligated under bond related to the Contract.

5.4.2 If the Work has been suspended for more than 30 days, the Subcontractor's compensation will be equitable adjusted.

14.2 TERMINATION BY THE OWNER FOR CAUSE

14.2.2 ...[T]he Owner...may without prejudice to any other rights or remedies of the Owner...terminate employment of the Contractor and may subject to any prior rights of the surety:

- .3 Accept assignment of subcontracts pursuant to Paragraph 5.4....

The analogous provisions from the 1997 editions of A401 and A201 differ from those in the 1987 versions by the following terms in bold:

1997 EDITION

A401 (subcontract form)

7.4 ASSIGNMENT OF THE SUBCONTRACT

7.4.1 In the event of termination of the Prime Contract by the Owner, the Contractor may assign this Subcontract to the Owner, with the Owner's agreement, subject to the provisions of the Prime Contract and to the prior rights of the surety, if any, obligated under bonds related to the Prime Contract. **In such event, the Owner shall assume the Contractor's rights and obligations under the Subcontract Documents.** If the work of the Prime Contract has been suspended for more than 30 days, the Subcontractor's compensation shall be equitably adjusted.

A201 (prime contract- general conditions)

5.5 CONTINGENT ASSIGNMENT OF SUBCONTRACTS

5.41. Each subcontract agreement for a portion of the Work is assigned by the Contractor to the Owner provided that:

- .1 assignment is effective only after termination of the Contract by the Owner for cause pursuant to Paragraph 14.2 and only for those subcontracting agreements which the Owner accepts by notifying the Subcontractor **and Contractor** in writing; and
- .2 assignment is subject to the prior rights of the surety, if any, obligated under bond related to the Contract.

5.4.2 **Upon such assignment,** if the Work has been suspended for more than 30 days, the Subcontractor's compensation will be equitable adjusted **for increases in cost resulting from the suspension.**

14.2 TERMINATION BY THE OWNER FOR CAUSE

14.2.2 ...[T]he Owner...may without prejudice to any other rights or remedies of the Owner...terminate employment of the Contractor and may subject to any prior rights of the surety:

....
.3 Accept assignment of subcontracts pursuant to Paragraph 5.4....

The 1997 documents are arguably an improvement over the 1987 editions from the owner's perspective in that the updated A201, Subparagraph 5.4.2, indicates that in the event of the owner exercising its assignment rights following the termination of the contractor, the subcontractor's remedy following a thirty day suspension of the work is limited to an equitable adjustment for increases in the actual costs caused by the suspension. The intent underlying the 1997 changes was to prevent a subcontractor from attempting to make a better deal with the owner after the contractor had been terminated.⁷ Contract and subcontract provisions such as those quoted above implicate all of the practical problems implicit in the surety exercising assignment rights over initial subcontracts, see supra, with the additional complication that these rights run in favor of the owner and not the surety. For this reason, in the limited situations where the exercise of assignment rights may be advantageous to the surety, the surety would likely invoke the rights afforded by the Assignment Clause of the Indemnity Agreement in lieu of attempting to benefit from those afforded to the owner. Nonetheless, in situations where the owner and surety are working together after a relatively straightforward termination and where it is likely that a completion option such as a tender or buy out could be in place within a relatively brief period of time, there may be reasons why it would be advantageous for the surety to have the owner invoke its own assignment rights in

⁷ Though the A401 Subcontract appears to require the terminated contractor's consent before an owner can assume the assignment of a subcontract, it appears from the pertinent language of A201 and A401, when read together, that the contractor's consent to an assignment is given as of the time that the prime contract is executed, with the consent to become operative and the assignment effective upon the contractor's termination and the owner's decision to invoke its assignment rights.

lieu of those available to the surety, particularly, if the re-negotiation rights of the subcontractor were explicitly made narrow by terms the bonded contract such as those embodied in Subparagraph 5.4.2 of A201, 1997 edition. The owner's willingness to invoke these rights for the benefit of the surety may dependent, in part, on the surety's willingness to hold the owner harm less against any additional claims from the subcontractor that may arise as a consequence of the assignment.

C. Consensual Assignments by the Contractor

As construction contracts are typically not treated as personal service agreements, a terminated contractor could presumably agree to assign one or more of the original subcontracts to its surety even in the absence of an Assignment Clause in an Indemnity Agreement. See p. 5-6, supra. The practicalities and advantages and disadvantages of this option are identical to those set out in connection with the surety's exercise of the Assignment Clause, with the additional element that the principal must consent to and initiate the assignment. See pp. 6-9, supra.

In sum, the exercise of assignment rights afford an excellent legal mechanism for binding initial subcontractors to complete their work on terminated projects under the terms specified in their initial subcontracts. However, given the practical problems associated with this option, such assignments are only likely to be feasible in a limited number of default situations.

III. Assignment of the Bonded Contract

Assuming that the principal is cooperative and that surety involvement commences before the bonded contract is terminated, it may be possible to have the principal assign the bonded contract to a completion contractor, with the surety paying the difference between the completion contractor's price and the undisbursed contract funds. In some cases,

it may be possible to convince an obligee to rescind a termination to facilitate such an assignment.

A principal advantage to assigning a bonded contract is that the subcontracts arguably remain fully operative and pass to the completion contractor, thereby obviating or reducing the leverage of a subcontractor to renegotiate its terms or walk away from the subcontract work in its entirety. As the surety is not a party to the transaction, there is no risk that the surety will be exposed to additional obligations beyond the scope of the bond.

The advisability of these kinds of assignments is discussed in a prior paper presented to the Northeast Surety and Fidelity Claims Conference.⁸ Suffice to say for current purposes that where the assignment of a bonded contract is an available completion option, a principal advantage of this option is that it keeps intact the contractor/subcontractor relationship.

IV. **Ratification Agreements**

An alternative to the process of directly assigning the original contractor's subcontracts to a party that would be responsible for project completion is the use of ratification agreements. When the Surety decides to utilize the original subcontractors in completing the defaulted project due to one or more of the reasons outlined in Section I above, ratification agreements are implemented more often than the assignment of contracts process. The reason for this is likely because ratification agreements allow the Surety and the original contractor to specifically define their relationship so that the Surety knows what its risks and exposures are. In the assignment process, however, the Surety steps into the shoes of its defaulted principal. Consequently, the Surety becomes exposed to the principal's liabilities under the assigned contract without the protection of the penal sum of the payment bond. Many of these liabilities would not necessarily be items that could be claimed against the payment bond Surety (such

⁸ See Matthew Horowitz, *Resolving Performance Bond Exposures Through Assignments of Bonded Contracts*, 15th Annual Northeast Surety and Fidelity Claims Conference (September 30, 2004).

as lost profits).⁹ The Surety is cautioned, however, not to allow a novation of the subcontract to occur that could arguably result in the cancellation of warranties and other rights that the original contractor may have had.¹⁰

Simple and straightforward ratification agreements serve the purposes of having the original subcontractor reaffirm its commitment to complete its work under the rights, duties and obligations of its original subcontract and defining the current financial status of the subcontract. Circumstances may dictate, however, that the Surety will either want to or be motivated by critical subcontractors to address many more issues in the ratification agreement than a subcontractor's commitment to the project and definition of the financial status of its subcontract. In strategizing the utility of ratification agreements in a given situation, the Surety will want to consider what it wants to accomplish by ratifying some or all of the original subcontractors, what clauses in a ratification agreement will best serve the Surety's goals, and various project completion scenarios in which ratifying subcontracts may or may not be useful.

This paper's analysis of ratification agreements is divided into two sections. The first section addresses issues relating to the content of a ratification agreement. The second section addresses the desirability of using ratification agreements and the issues posed by their use depending upon the completion option selected by the Surety.

A. Clauses to Consider Including in a Ratification Agreement

There are a number of draft ratification agreements contained in various surety publications.¹¹ One form of sample ratification agreement is attached as Exhibit A to this

⁹ Certain courts have held, however, that where a surety executes a ratification agreement that incorporates a subcontract, the surety becomes bound by an arbitration clause in the subcontract. See Employers Insurance of Wassau v. Bright Metal Specialties, Inc., 251 F.3d 1316 (11th Cir. 2001); Structural Steel Fabricators, Inc. v. Travelers Casualty & Surety Co., 801 N.Y.S.2d 242 (N.Y. Sup. Ct. 2005).

¹⁰ James W. Smirz, Takeover Agreement and Maintaining Existing Subcontractors and Suppliers For the Takeover Contract (unpublished paper submitted at the A.B.A. Tort and Insurance Practice Section Fidelity & Surety Law Committee annual meeting in New York, NY on August 12, 1986).

¹¹ See, e.g., Practical Guide to Construction Contract Surety Claims, Tasker, Richard E., Murphy, G. Wayne, and Schwartzkopf, William (Aspen Law & Business, 1997), Forms 10-8 and 11-8; Bond Default Manual, 2d ed., Clore, Duncan L., editor (American Bar Association, 1995), Exhibit 5.7.

article. The form in Exhibit A and the ones footnoted below are similar in that they are simple forms.¹² The Surety is generally better served by attempting to keep the ratification process as uncomplicated and straightforward as possible. The more issues that the Surety tries to resolve in a ratification agreement, the more complex it becomes and the more likely it is that the subcontractor will engage counsel. Having to address the issues that may be raised by a sophisticated subcontractor, such as delay and impact claims, complicates and delays the ratification agreement process.¹³

The sample "Exhibit A" ratification agreement attached hereto contains clauses that: 1) identify the subcontract documents that will govern the subcontractor's completion effort; 2) define the financial status of the subcontract; 3) get the subcontractor to reaffirm its commitment to completing the work under the terms defined in the agreement and the subcontract incorporated therein; 4) assign to the Surety any claims that the Subcontractor may have against the original contractor and the owner except for retainage and waive all other claims (including any claims against the Surety); 5) lock in the price for the completion of the Subcontractor's work; and 6) get the Subcontractor's consent for the Surety to assign the agreement to another entity that may complete the project. In exchange for these understandings, the Surety consents to issue an agreed upon payment immediately upon execution of the agreement.

A ratification agreement will grow in complexity the more goals the Surety tries to accomplish in the agreement and the more key subcontractors try to either settle or reserve disputed claims. First and foremost upon default of the original contractor, the subcontractors want to get paid as soon as possible for labor and materials furnished to the project prior to default. The subs' claims for nonpayment will likely include unresolved change orders and

¹² Care should be taken to adapt these forms to the laws of a particular jurisdiction and/or the particular terms of the original subcontract or the bonded contract.

work that has been furnished but not yet billed, inspected and/or approved by the owner. In any project halted by default, there are typically a number of change order issues that have not been fully formalized where, despite the language of the general contract and the subcontracts, work has at least been partially performed on the change order work without written authorizations and executed change orders. Flushing out these pending change order issues is critical also to the Surety in negotiating the terms of a takeover or tender agreement with the owner and the respective financial responsibilities of the parties. Furthermore, reaching agreements on pending change order issues minimizes the Surety's risk of making commitments to a subcontractor without getting commitments of commensurate payment from the owner for the extra work. The Surety and subcontractor can then attempt to resolve payment and change order issues by adjusting line items in the ratification agreement that address change orders, adjusted subcontract amount, value of work completed, and sums currently due (see, line items (b), (c), (d) and (h), Exhibit A) or they can agree to reserve the subcontractors' claims for extras. Disputes as to the percentages of work completed should be resolved as the subcontractor recommences its work and bills the completion contractor for the work performed.

Secondly, the subcontractor will sometimes seek payment for delay and impact claims, as well as demobilization and remobilization expenses allegedly caused by the original contractor prior to as well as stemming from the default. Legally, the Surety may have any number of defenses to the consequential damages claimed by the subcontractor. Practically speaking, however, the Surety may be motivated to negotiate settlement of these claims if the subcontractor is acknowledged to be critical to job completion. If a critical subcontractor's claims for impact and delay are left unresolved, or worse, headed to litigation with the Surety, its motivation and cooperation during the completion phase of the work will be questionable

¹³ Attached as Exhibit B is a Ratification Agreement memorializing the results of a complicated negotiation and

even if payment for its prior contract work is settled (as above) and its revised completion contract price is resolved (as below). As significantly as the subcontractor's motivation and cooperation, the Surety risks overpayment of the sub's claims if it negotiates a revised completion price with sub (as below) and reserves the settlement or litigation of the sub's impact and delay claims for a later date. A wise and savvy subcontractor will undoubtedly minimize its risk for claim nonpayment by hiding at least part of its claim costs in its proposed completion price to the Surety.

Lastly, the Surety may find it prudent to negotiate revised completion prices with some key subcontractors during the ratification agreement process. Regardless of how quickly the Surety performs its default investigation, subcontractors will frequently take the position that their subcontracts terminated when the original contractor's contract was terminated for default. As discussed in Section I above, the Surety may have a variety of contractual provisions at its disposal to argue against the automatic termination of subcontracts depending on the terms of the general contract, the subcontracts and the General Agreement of Indemnity. Despite the legal arguments that may be available to the Surety, subcontractors may have little or no interest in returning to a troubled job, especially when re-commencement of work has been long delayed. Where a subcontractor is deemed critical to job completion due to any number of factors, including the reasons set forth in Section I above, and the estimated cost of hiring a replacement subcontractor is high, the Surety may look to negotiate a revised contract price with the sub during the ratification agreement process.

In situations where the Surety resolves outstanding contract payments, change orders, demobilization and remobilization costs, delay and impact claims and revised costs to complete in the ratification agreement process, the Surety would amend the accounting line items of the ratification agreement accordingly. The Surety would increase the value of the

incorporating the kind of detailed provisions that may be demanded by a sophisticated contractor.

approved change order line (see, line item (b) in Exhibit A) in order to increase the value of the revised subcontract (line item (c), Exhibit A). Then it can funnel some of these funds to the subcontractor (to pay for delay and impacts prior to default, for example) at the time that the agreement is executed by adjusting the value of the work completed to date and the amount currently due (line items (d) and (h), Exhibit A). The balance of the agreed upon funds would be disbursed to the subcontractor by the completion contractor as completion of the project progresses.

One of the major difficulties in negotiating a revised completion price with a subcontractor during the ratification agreement process is that the completion contractor or construction manager has not yet been contracted. Therefore, the completion construction schedule will likely not have been established. Consequently, the sub does not know when it will start its work and when it is expected to be completed. The start and stop dates may affect the subcontractor's price, particularly if it could involve winter work or traditional periods of high activity such that the sub would have to employ a great deal of overtime labor in order to meet the completion contractor's schedule. If a subcontractor insisted that such matters be negotiated and addressed by a ratification agreement, the Surety could estimate the start time and the duration of work for the subcontractor so that it could estimate its cost. The Surety could insert a clause in the ratification agreement that would allow for an escalation in price if the completion construction schedule is not met for reasons for which the sub is not responsible (see Exhibit B, paragraph 4). In jobs with sophisticated and sensitive equipment that was exposed to the elements during the project shut down period (for example pumps, switch gear, motor control panels), a subcontractor would likely not be able to give a revised completion price until the equipment is inspected and tested. Furthermore, depending on the extensive nature of testing or its invasiveness, the sub may not even want to price the cost for such testing. Paragraph 8 in Exhibit B address this issue and the pricing for patent defects

that are identified during the inspection and testing process. The overhead and profit figures are numbers taken from an underlying contract in an actual case and are not intended to be representative of the typical scenario. Paragraph 9 in Exhibit B is intended to address latent defects that are not identified during the inspection and testing phase but which arise during construction.

B. Practical considerations regarding how the surety's decision on completion options bear on the desirability of using ratification agreements

Once a ratification agreement has been executed, it can be assigned to a completion contractor, a construction manager, the owner or remain with the Surety. Contemporaneously with the ratification agreement negotiation process, the Surety is continuing its claim investigation and evaluating the best course of action for completing the defaulted project. In the course of its investigation, the Surety will either determine itself or obtain from consultants an estimate of the cost to complete the defaulted project. A good estimate will have broken down the various items of work left to complete along with cost estimates to perform each segment of the work. This cost estimate will assist the Surety in negotiating the completion of the project regardless of the method chosen by the Surety to complete the project. What follows is a discussion regarding the practical considerations facing the Surety in choosing from a variety of methods to complete a job and some recommended suggestions for resolving problems that may arise in the different scenarios.

1. The Surety Completes Itself:

An increasing number of sureties have hired an internal staff of engineers and accountants to complement their claims professionals. Depending on the scope and complexity of the job completion at issue, the Surety may choose to complete the project using its own in-house resources. Regardless of the mechanism chosen to complete a project, each job completion effort typically needs to employ a project manager, a job superintendent and

accounting or bookkeeping back-up to process pay applications, change orders and progress payments. These functions could be staffed by the Surety's own personnel or through the employment of consultants.

When the Surety elects to complete a job itself as the completion contractor, the option of using of ratification agreements will generally be desirable for the Surety, with the ratification agreements remaining with the Surety throughout the completion process rather than being assigned to a third party. The Surety's in-house project manager (typically the claim professional or the Surety's chief engineer) and the project superintendent (the Surety's chief or staff engineer) would manage and direct the work of the ratified subcontractors. The Surety would have each subcontractor name the Surety as an additional insured on its insurance policies. However, before embarking on this option, the Surety should nonetheless obtain project-related insurance in its own name not only to fulfill the insurance requirements of the general contract, but to protect itself from any gaps of coverage that would remain after the subcontractors have named the Surety as an additional insured. Naturally, the option where the Surety completes the project itself would be the most labor-intensive choice for the Surety. However, it may be the Surety's best option if the job is a straightforward construction project with few or no complicated systems left to install. Also, this option would seem more viable the farther the defaulted contract was toward completion. A word of caution is warranted, however, in that the Surety must determine whether it needs to have a general contractor's license in order to execute construction work in a given jurisdiction.

Where the Surety acts as the completion contractor, there is no entity other than the Surety to perform the general conditions function on the job. One method to cover the general conditions on the project would be to hire a construction company to perform such functions as general project clean up, general and rough carpentry, spot painting and a number of other issues that arise on such jobs. Another method for satisfying the general conditions

coordination on the project is to expand the ratified subcontractors' responsibilities through the appropriate change orders. For instance, the original contractor may have been supplying a crane, hoist elevator and/or scaffolding to the project for various subcontractors to use. Rather than execute new subcontracts to arrange for such services, the Surety may expand the ratified subcontract of one or more subcontractor by change order.

Despite the fact that this option would tax the internal personnel resources of the Surety, the Surety may choose this as its most desired option if the estimated or actual re-let premium that a completion contractor or construction manager would charge is deemed to be exorbitant. Should the Surety decide that it either does not have the in-house resources to manage a contract completion itself or through the use of consultants or if the re-let premium from a completion contractor is deemed to be reasonable, the Surety may choose another completion option.

2. The Owner Completes

Whether by design or due to the break down in negotiations between the Surety and the owner, the owner may choose to complete the defaulted project itself. The desirability of using ratification agreements where it appears that the owner intends to complete depends on the circumstances, including the particular relationship between the owner and the Surety. Where ratification agreements are executed and it later becomes evident that the owner intends to complete, the use of the agreements will also depend on the particular circumstances.

The downside of executing ratification agreements where the owner later decides to complete is that the owner may decide not to use the ratified subcontractor, thereby possibly resulting in the Surety receiving no net financial benefit in exchange for any financial concessions made to the subcontractor. On the other hand, ratification agreements may prove to be financially advantageous to the Surety even where the owner decides to complete.

If the relationship with the owner is friendly or, at least not strained, the Surety may be able to assign the ratification agreements to the owner. The owner could then assign the agreements to the completion contractor it obtains to accelerate the completion process, thereby theoretically reducing the project's completion cost. Should the relationship between the Surety and the owner be acrimonious or break down entirely such that the owner would not accept assignment of the ratification agreements, the completion prices contained in the ratification agreements would at least provide a benchmark for the completion cost for which the Surety believes it is responsible. The collective value of the ratification agreements together with some estimated costs for general conditions and contract items that had not been bought out by the original contractor would form the basis for determining the Surety's financial responsibility. The Surety would likely argue that the owner would be responsible for any completion costs in excess of the ratification agreement prices and limited additional estimated costs. Should the Surety's performance bond responsibility have to ultimately be determined by litigation, the Surety would then be in a better settlement or litigation posture by having the majority of its completion cost estimate comprised of subcontractors' prices locked in by ratification agreements rather than comprised solely from an estimate of completion prices. A completion price based solely on an engineer's estimate can be rebutted by empirical data compiled by the owner during the completion process. The Surety would be primarily left with having to argue about the unreasonableness of the owner's completion prices and its failure to mitigate damages.

Therefore, ratification agreements may or may not be a valuable tool where an owner decides to complete, depending on the particular circumstances.

3. The Surety Completes Using a Completion Contractor

The Surety will generally favor the use of ratification agreements where it successfully negotiates a takeover agreement with the owner and determines that its best course of action

for completing the defaulted project is to hire a completion contractor. In this circumstance, it becomes incumbent on the Surety to carefully coordinate the text of its ratification agreements with the text of the contract negotiated with the completion contractor so that the Surety realizes the full benefit from the ratification agreements.

Typically, the Surety will incorporate the original contract by reference into the completion contract. Therefore, the contracted delivery system for project completion would be the same as the one contracted for by the original contractor. There would then be no dissimilarities between the general contract incorporated by reference into the ratification agreements and the general contract that the completion contractor agreed to perform. If the terms of the completion contract deviate from those of the bonded contract, it is critical that the Surety assess how these deviations should either be addressed in a ratification agreement to be negotiated or how these deviations bear on the utility of previously executed ratification agreements once these are assigned to the completion contractor.

The Surety will want to have the completion contractor break down its price among the various divisions of work necessary to complete the project. The timing of the Surety's negotiations on ratification agreements is an important consideration for the completion contractor. If the completion contractor intends to use the original subcontractors to complete the project then it needs to incorporate the subcontractor's prices into its completion price. Furthermore, the completion contractor needs to evaluate and analyze the project completion and discuss it with the subcontractors it is going to use to complete the job in order to develop its strategy for project completion.

The completion contractor may break the project down differently from the original contractor. It may then look to shift some of the contractual responsibilities around so that the subcontractors have slightly different scopes of work to complete from that which remained in their subcontracts at the time of the default. If the ratification agreement prices are already

locked in, then theoretically, an increase in scope of work to one subcontractor would be offset by a commensurate decrease in the scope of work of another subcontractor. However, the Surety will have to be involved in the price discussions for the changed scope of work so that the cost resulting from shifting scopes of work around does not unnecessarily escalate the overall price. The Surety would not have to revise its ratification agreement prices, but the ratification agreements would be amended by the completion contractor after assignment in order to address the shifting work scopes.

Additionally, the subcontractors' scope of work may change as the completion contractor seeks to incorporate items of work into the ratified subcontracts that were not previously bought out by the original contractor. The Surety will be responsible to the completion contractor for the increased prices resulting from the additional scope of work to subs from the buy out gaps caused by the original contractor. However, the Surety should evaluate whether the issues in question resulted from true buy out gaps of the original contractor, unresolved change orders or inaccurate or false interpretations by the subcontractors as to the scope of its original or revised subcontract. Alleged buy out gaps may actually be a second attempt by subcontractors to convince a contractor to pay for a scope of work that the subcontractor missed in its bidding process but for which it subcontracted to perform nonetheless. By ratifying its subcontract, the subcontractor has recommitted to performing its work at the price quoted in the ratification agreement. It must complete the full scope of its work, including punchlist and warranty work, and it should not have the opportunity to re-negotiate its price to cover the price of items that it inadvertently omitted from its original bid.

On the other hand, the owner and/or its design and engineering team may look to inadvertently or intentionally shift the financial responsibility for some change order work that had not been executed prior to default to the Surety. Allegations of buy out gaps may actually camouflage design deficiencies so that the owner may try to get the Surety to pay for work that

is not depicted on the project's plans and specifications. Ratification agreements do not resolve this problem that would exist whether or not the original contractor was defaulted. However, the ratification agreement process should flush out these issues.

Further complications arise when the completion contractor either refuses to use a particular subcontractor that executed a ratification agreement or insists on using its own subcontract, thus disregarding the ratified subcontract. In both instances, the Surety is still protected by the ratified subcontractors' prices. In the first situation, the Surety has a benchmark price to compare against the completion contractor's price for the same division of work. As long as the scope of work for the sub that the completion contractor wants to use and the ratified sub are essentially the same, the Surety may refuse to pay the completion contractor the excess cost caused by that contractor's desire to engage a different subcontractor. Hopefully, the two parties can reach a negotiated solution should the completion contractor refuse a reduction in its completion price (whether this matter can be resolved may depend on the reasons for the completion contractor's reluctance to use the ratified sub).

More difficult to resolve is the second situation above where the completion contractor agrees to use the former subcontractor but insists that the subcontractor either execute the completion contractor's own form of subcontract or consent to the incorporation of specific clauses into the ratified subcontract. For example the completion contractor may insist on the inclusion of "no damage for delay" or "termination for convenience" clauses that were not included in the original subcontract. Or the completion contractor may require that the subcontractor be responsible for actual damages in addition to liquidated damages in the event that the sub causes a project delay. Consequently, the subcontractor would likely come back to the Surety seeking additional funds claiming that its risks of financial exposure on the job have increased. If the Surety is unsuccessful in convincing the completion contractor to drop

its contractual demands or unable or unwilling to provide a hold harmless agreement to the completion contractor to cover the exposures that the contractor wants to pass down to the subcontractor, the Surety may have to pay the subcontractor or completion contractor more money. The Surety could revise the amounts currently due under the ratification agreement or enter into a side agreement capping the additional funds to be paid by the Surety upon the subcontractor's presentation of documented additional completion costs actually incurred during the completion process resulting directly from the completion contractor's additional contract terms. This problem may be prevented or at least mitigated if the Surety and the prospective completion contractor reach understandings regarding the use of the original subcontracts during the completion bidding process.

In sum, ratification agreements will likely be a valuable tool where the Surety takes over a contract and retains a completion contractor, but there is a compelling need in these contexts to carefully coordinate the text of the ratification agreements with that of the completion contract.

4. The Surety Tenders a Completion Contractor or Construction Manager to the Owner

Under the ideal tender scenario, the owner accepts a tender from the Surety of a completion contractor along with a check representing the difference between the remaining contract balance and the estimated completion cost, the owner releases the Surety from further exposure under the performance bond, the completion contractor agrees to complete the original contract, and the completion contractor agrees to use the original subcontractors bound by ratification agreements. Under this scenario, the use of ratification agreements can assist the Surety in securing relatively smooth closure to a performance bond claim. Having executed ratification agreements reduces the unknowns associated with typical default project completion and goes a long way toward convincing the owner that the tendered check by the

Surety will cover all anticipated completion costs and convincing the completion contractor to accept a more reasonable completion price.¹⁴

Tender negotiations are sometimes far more complicated than that described above and these complications can, in turn, raise issues as to whether the use of ratification agreements would be desirable and, if so, the content and timing of such agreements.

One problem may arise in the event that the completion contractor insists on using its own subcontract form or incorporating certain provisions of its subcontract form into the ratified subcontracts. Another problem may arise if the completion contractor is not inclined to use one or more of the original subcontractors. These issues are discussed above in the context of the takeover and completion of a project. However, unless the Surety has worked out the subcontract issues with a tendered contractor beforehand or a tri-party agreement is used to accomplish the tender arrangement, the issues posed in the tender context may differ from those in the context of a take over since the Surety may not be in control of the negotiations with the tendered completion contractor. The Surety would then be left with having to try to convince the owner to insist that the completion contractor use the original subcontractors and the form of subcontract used by the original contractor. However, the owner may not wish to make such an insistence. The likelihood of these issues arising may cause the Surety to consider the desirability of using ratification agreements to the extent that it appears that the performance bond claim will be resolved by a tender.

Another complicating factor bearing on the use of ratification agreements is where the owner looks to use a different project delivery system for job completion from the one contained in the original contract and wants to structure a tender arrangement on that basis. One implementation of a new delivery system would be changing from a hard bid lump sum

¹⁴ However, if the tender agreement does not release the surety from further financial responsibility for latent defects or defective work, the Surety will likely still want to be involved in evaluating the responsibility for latent

contract to a construction manager with fixed fee or fee at risk. Depending on the complexity of the project and the surrounding market conditions, there may be a paucity of qualified, competent contractors willing to bid on a lump sum completion contract with unknown risks. Additionally, holding fast to a competitively bid, lump sum contract price approach on a complex job with significant unknown risk may result in an arbitrarily high completion price as the contractor has to build in contingencies for the risk it is being asked to assume. Allowing a construction manager to study the project and evaluate risks while initiating some construction may on its face present the best opportunity to deliver the project in an expeditious fashion while avoiding price escalation for unknown risks through the closed bid, lump sum price approach.

Under the circumstances described above, the Surety may consent to the owner's wish to engage a construction manager with at least a partially guaranteed fee as the tendered contractor rather than a lump sum price contractor. A reason for the Surety's consent could be that it is trying to reach some accommodations with the owner to increase the chances for an expeditious project completion in exchange for owner concessions on liquidated and/or actual damages resulting from the default, contested change orders and other factors.

The owner's interest in accepting a buy out from the Surety and funding a completion mechanism different from that in the bonded contract may complicate negotiations regarding a tender in innumerable respects. There may, however, be reasons why a Surety would be prepared to discuss a tender under these circumstances. Under these circumstances, having a completion contract different from the original contract raises questions as to the efficacy of using ratification agreements since these would incorporate a different general contract from the new one to be used in project completion. Where an owner seeks a tender predicated on a revised delivery mechanism, the Surety will need to carefully consider whether ratification

defect work and work damaged during the project shut down period that could be covered by insurance and not

agreements would yield a net benefit. If a Surety facing a “tender/revised contract” scenario has entered into one or more ratification agreements, it will want to analyze the construction management agreement offered to the completion contractor in order to identify clauses that may result in completion price escalation. There may be additional risks passed on to the construction manager in the construction management agreement compared to the risks assumed by the original contractor. The construction manager may, in turn, pass the additional risks on to the subcontractors, especially if the construction manager uses its own subcontract form that incorporates the new “general contract” by reference. The subcontractors may take the position that their ratification agreements do not bind them to complete a different contract and may use this argument to either look to the Surety to give them more money due to increased risk, or increase the completion prices that they submit to the construction manager. Naturally, the construction manager will pass these increased costs on to the owner and the owner will seek to increase the buy out price offered by the Surety.

Nonetheless, even under this complicated scenario, the use of ratification agreements may, depending on the particulars, yield a net benefit. Ratification Agreements or a variant of these agreements may be desirable in order to secure a commitment from a subcontractor to return to the project while the terms of a settlement of a performance bond claim are being negotiated. In addition, having many of the original subcontractors under ratification agreements, allows the Surety to easily calculate the price associated with the accommodation to the owner in consenting to a different delivery system. The owner would be receiving a benefit from the increased chance for expeditious project completion rather than facing further delays stemming from a protracted lump sum completion process that would involve development of a re-bid package, perhaps a revised set of drawings that conform to all the changes and explanatory sketches developed prior to default (this would be more likely on a

the performance bond.

very complex and sophisticated project), and the delays that will undoubtedly result from arguments over patent and latent defects because the contractor had insufficient time to study the project during the competitive bidding process. Arguably, the price for this convenience is the difference between the collective ratified subcontracts along with additional estimated costs for general conditions and buy out gaps and the price submitted to the owner from the construction manager after getting revised prices from the subs due to the increased risks and costs passed down to the subs under the new delivery system. Thus, depending on the circumstances, ratification agreements may facilitate complicated negotiations between the Surety and the owner regarding a tender or buyout price even where the owner introduces the additional complication of a different completion mechanism.

In sum, ratification agreements may facilitate the Surety's successful exercise of a tender, though their desirability and the content of these agreements in these contexts depend on a careful evaluation of the unique facts underlying the available completion options.

IV. **Conclusion**

A critical issue in a Surety's evaluation of a defaulted project is whether to facilitate the return of the original subcontractors to complete their work on the project and, if so, the most effective and cost efficient vehicle for doing so. The primary tool for binding the original subcontractors to the project remains the ratification process, though the invocation of an assignment option may sometimes be advantageous. While it is possible to identify issues and considerations that may arise in the course of this process, every completion context is ultimately unique. Therefore, strategies for addressing the original subcontractors should be developed on a case by case basis only after a careful and particularized analysis of the issues posed by the defaulted project.

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Greg started his surety claims career with Great American Insurance Company in Orange County, California and then transferred to Great American's Home Office in Cincinnati, Ohio. He then accepted an officer's position in the Claims Department of Highlands Insurance Company in Houston, Texas. Before accepting a position in the Bond Claims Department of Hanover, Greg founded Claims Management Associates, Inc, providing primarily desk relief and run-off assistance to smaller sureties in transition.

Greg is a regular attendee at surety industry events, such as the TIPS Mid-Winter Meetings; The Forum on the Construction Industry; the Surety Claims Institute Annual Meetings; the National Bond Claims Association Annual Conferences; the annual Northeast Surety & Fidelity Claims Conferences; the Chicago Surety Claims Association Monthly Meetings; and others.

Greg was quoted in *Insurance Week Magazine, If It's Not Illegal...It's Bondable*, March 1998, was a contributing writer for the TIPS *CGL, Builder's Risk, and Surety Claims* Monograph published in 2004 by the American Bar Association, and has presented papers and participated on panels during various national surety educational events. These include: "The Surety's Good Faith Investigation", presented at the CMA Group, Inc. National Claims Conference in Chicago, IL, April 25, 1989; "The Good, Bad and Ugly - Lawyers, Consultants and Company People - Traveling Down The Same Road Together", a panel presentation at the National Bond Claims Conference, Pinehurst, NC 1994; and *Treatment of Pay-When-Paid Clauses Under Federal Law on Bond Projects in Virginia*, presented at the Surety Association of South Texas, San Antonio, May 17, 2000.

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