PLATFORM INSURANCE MANAGEMENT

Performance Security Overview

The Need For Security

- Guarantee completion of a contractual obligation
- Protection of investment/capital
- Lender requirement
- Protection of tax dollars
- Incentive to perform

Most Common Security Options

- Self-Insurance
  - Unfunded
  - Funded
- Increased Retainage
- Letter of Credit
- Surety Bonds
- Subcontractor Default Insurance
- Insurance

Considerations

- Reputation of the counterparty
- Scope of work
- Risk tolerance
- Financing benefits
- Third-party requirements
- Owner experience with default resolution

SURETY BONDS

What Is Surety?

Definition

A formal engagement (as a pledge)
given for the fulfillment of an undertaking

One who has become legally liable for the
debt, default, or failure in duty of another

Surety's Use In Canada

- Long history of use in Canada
  - Oldest Surety in Canada is over 140 years old
- Widely used by all levels of government
  - Security for projects that use public funds
- General contractors can use to address risk of subcontractor performance
- Lenders may require as a condition of financing
  - Want an asset for loan security
- Not as strong a demand from private sector owners

Key Points on Surety

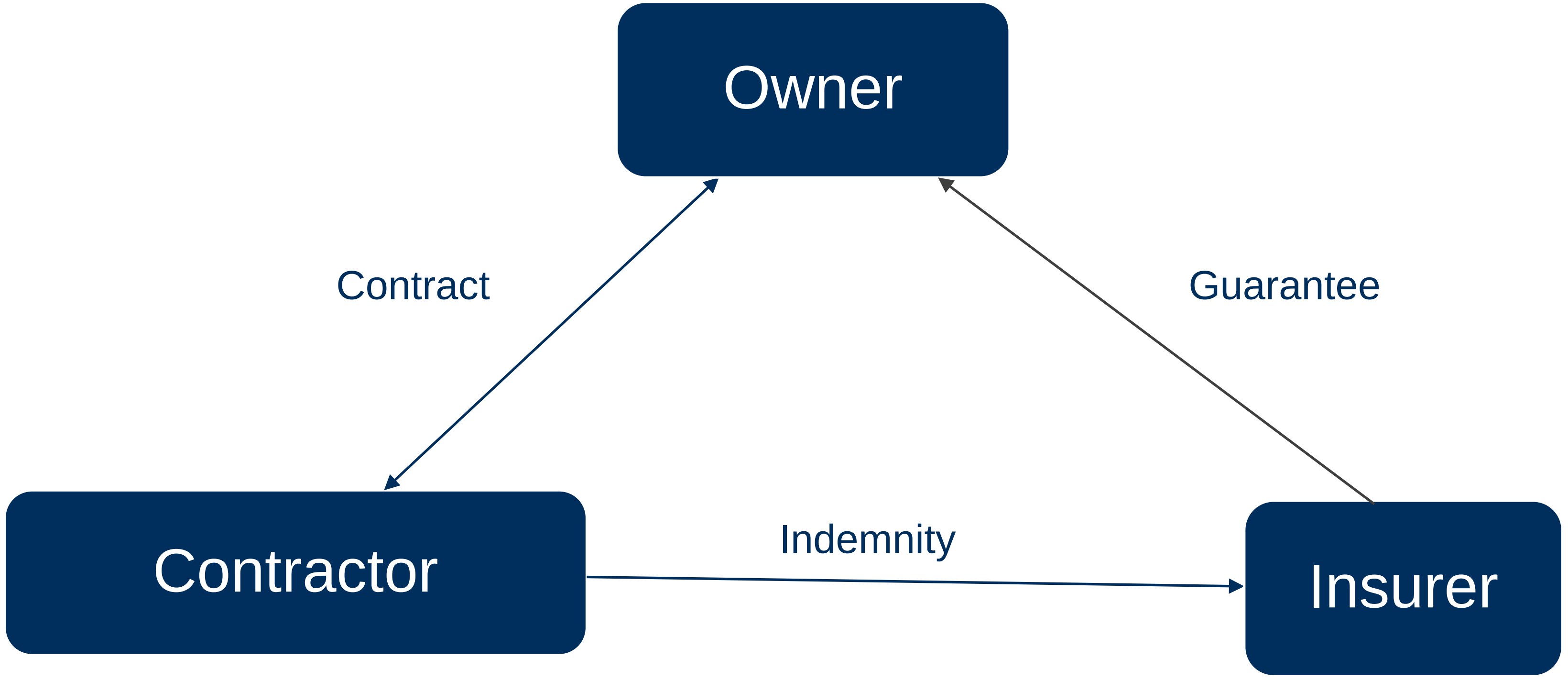
- Three party agreement
  - Principal
  - Obligee
  - Surety

- Provides security against performance of a contractual obligation
  - Indemnifies the Obligee against the default of the Principal

- Don’t think of it as insurance
  - Underwriting is more in line with banking than traditional insurance
  - Underwritten to a zero loss basis (3 C’s of underwriting)

- Secured through and indemnity agreement
  - Agree to repay the Surety in the event of loss

Surety Relationship



Types Of Bonds

RFQ

- Prequalification Letter / Sunshine Letter

RFP

- Bid Bond
- Agreement To Bond (Surety Consent)

Contract Award

- Performance Bond
- Labour And Material Payment Bond

Post Award

- Maintenance Bond
- Lien Bond

Prequalification Stage

- Prequalification Letter
  - Issued on behalf of the insurance company
  - Confirms that a facility is in place
  - Often acknowledges the project and budget
  - Key is that it is non-committal and non-binding

- Sunshine Letter
  - Issued by the broker on their own letterhead
  - States the same points as a prequalification letter
  - May not be acceptable to all parties

Tender Stage

- Bid Bond
  - Submitted as part of a tender package
  - Provides assurance that low bidder will enter into a contract if awarded
  - Pays the difference between low bid and next lowest responsible bidder
  - Typically 10% of tender amount (can be a fixed dollar amount)
  - Signed by Principal and Surety

- Agreement To Bond
  - Also known as a Surety's Consent
  - Identifies the bonds required if successful
  - Agreement that if Principal is awarded the contract, the Surety will issue the specified bonds
  - Signed by the Surety only

- Both bonds are tied to the validity period of the contract and must be sealed by the surety

Contract Award

- Performance Bond
  - Guarantees completion of the Principal’s contractual requirements
  - Typically for 50% of the value of the project, but can be for 100%
  - Signed by both the Principal and Surety
  - Typically cannot be cancelled
  - Premium payment involved
    - *Be sure to include premium in your bid at the tender stage*
    - *Annual vs. long-term rates*
    - *Premium is based on contract price plus HST*

- Labour And Materials Payment Bond
  - Protects against the Principal’s failure to make payment to first-tiered subcontractors/suppliers
  - Subcontractors can claim against the bond for non-payment
  - Broad form is available
  - Value will be the same or less than the performance bond – Cannot issue in isolation
  - Premium payment involved

Other Types Of Bonds

- Maintenance Bond
  - Guarantees warranty obligations
  - Performance bond will address warranty as well
  - Most are for 10% the value of the contract or less

- Lien Bonds
  - Contracts typically call for a contractor to vacate any and all liens
  - Posted as security with the courts to vacate the lien
  - Surety’s are reluctant to issue when no performance bond is in place
    - *Lien is a sign of a dispute*
    - *Capacity is often limited, even for established companies*
  - Bond is required to remain in force until released by the courts
  - Copy of court release needed before a bond can be closed out
  - Premium is billed annually for duration of the bond.

Other Types Of Bonds

- Release Of Holdback Bond
  - Securing the early release of holdbacks may be beneficial
  - Percentage of contract amount required to be withheld from each payment
  - A bond can be put in place as an alternative to holding back funds
  - Allows the contractor early access to funds

Claiming Under A Bond

- Principal must be formally declared in default
  - Notice must be filed with the surety in the time-period indicated on the bond
  - Must actually be in default and owner must not be in default
  - Owner must not have jeopardized the surety's position

- Notice must detail key points
  - Formally declare the principal to be in default
  - Confirm the date of default and identify the bond being claimed against
  - Specifically state that a claim is being made against the principal's bond
  - Supporting documents need to be provided (original bond, contract, other info)

- Options under a performance bond
  - Pay the lesser of the bond amount or the proposed cost of completion
  - Remedy the default
  - Complete the contract
  - Obtain bids for submission to the Obligee for completing, paying the difference in cost

Indemnity Agreement

- Key security document for a surety
- Principal agrees to hold the surety harmless in the event they are required to pay out under the bond.
- Guarantees may not be limited to the operating company
  - Affiliated companies and holding companies
  - Personal indemnities
  - Spousal indemnities
- Grants the surety rights in the event of a claim
- Should always have the document reviewed by your lawyer

EVOLVING SOLUTIONS

Changing Landscape

- Public Private Partnerships – Lender controls security
- Drive towards more responsive security
- Letters of credit have been most common
  - Lenders may have a bias
- SDI helped bring insurance back to the table
- Bonds have become more liquid and responsive
- Seeing liquidity being introduced in other bonds

Letter of Credit

- On-demand instrument
  - No need to prove default
  - Could be a requirement to sign a declaration.
  - More conditionality being introduced

- Typically 10% of the contract value

- Procuring party has cash to fix a default
  - Need to have the expertise to address remediation

- Provides significant leverage over contractor

Letter of Credit

- Banks typically require full collateralization
  - Can restrict cash that would be available to address issues
  - Can tie up available credit facilities
- Says little about the ability of the providing party to perform
  - If you have cash, you can get a letter of credit
  - Very little in the way of prequalification
- Cancellation provisions typically require a notice provision
  - Failure to renew can lead to the holder cashing the letter of credit
  - Will hold the cash to address security
- Significant potential for high opportunity costs

Subdivision Bonds

- Guarantees completion and adherence to the underlying subdivision development agreement

- Surety industry has recognized the need to introduce liquidity

- Trigger under the bond is notice of default. Municipality is not required to prove default to claim

- Surety can tailor the bond language to meet the specific needs of the municipality and the agreement

- Frequently used in the U.S. and starting to see uptake in Ontario

Comparison: LC vs Subdivision Bond

	Letter of Credit	Subdivision Bond
Issuer	Chartered Bank of Financial Institution	Licensed Insurance Company
Regulation	Office of the Superintendent of Financial Institutions	Office of the Superintendent of Financial Institutions
Financial Ratings	S&P, Moody’s and DBRS	S&P and AM Best
Cancellation Provisions	30-60 days – If not replaced, cashed	60 days – If not replaced in 30 days, then automatically renewed
Action Upon Cancellation	Claim against the LC and hold funds	Replacement security is provided or bond is automatically extended
Proof Of Loss	May require certificate confirming amount claimed and that funds are owed	Declaration of default under the subdivision agreement. Not required to prove the default

Comparison: LC vs Subdivision Bond

	Letter of Credit	Subdivision Bond
Loss Documentation	Certificate is required. Developer will ask for an accounting of expenses	One page notice of claim. At conclusion of claim, surety will want an accounting of expenses.
Payment Timelines	Silent on timeline, but typically 1-3 business days	Negotiated, but can be between 7 and 30 days.
Required Recourse	Not required to pursue recourse	Not required to pursue recourse
Prequalification	No prequalification provided and provides no insight to capabilities	Surety will review the financial position as well as the experience and resources needed to deliver on the underlying obligations
Cost of Instrument	Average of 75bps to 150bps	Average of 75bps to 150bps
Amendments	Can be readily increased or decreased via endorsements	Can be readily increased or decreased via endorsements

Advantages Of Subdivision Bonds

- The provisions of letters of credit is not a sustainable model for developers
  - Tail exposure can be several years
  - Cash collateral often required on letters of credit

- Bonds provide a level of prequalification to the Municipality not found in other security

- Typically based on the corporate guarantee. Does not tie up a balance sheet
  - Avoids significant opportunity costs
  - Leaves cash free to address any issues that may arise

- Acceptance of alternate forms of security sends a message to the development community
  - Municipality is innovative, business a development oriented, all with no extra risk to the municipality

Thank You!