

# Contractual Risk Assessment for Construction Contractors:

## Anticipating Surety Concerns to Manage Risk and Streamline Bond Approval

When a surety provides contract bonds to a contractor for a construction project, the construction contract is one of the major areas they may want to review beforehand. In this document, we highlight the key areas your surety provider will focus on and ways to address surety concerns in construction contracts.

Before we go any further, it's important to understand what surety bonds are. In simple terms, a surety bond is an agreement among three parties. Typically, these parties are the surety company (guarantor), the contractor (principal) and the project owner (obligee). The project owner may be a private business or a public entity such as a government or a crown corporation.

### There are three basic types of contract surety bonds:

- **Bid Bond** – Provides financial assurance that a bid has been submitted in good faith, the contractor intends to enter into the contract at the price bid and the contractor will provide the required performance bonds, as well as payment bonds.

**Contractual risk can complicate bond approval for contractors. Addressing surety concerns in construction contracts can help contractors manage risk, streamline the bond approval process, and empower everyone's understanding as to what's in the construction contract.**

- **Performance Bond** – This bond assures that the contractor will perform the construction contract as specified. If the contractor fails to meet the obligations of the contract, the surety company will see that the work is completed.
- **Labour & Material Payment Bond** – Guarantees that the contractor will pay specific subcontractors, labourers and material suppliers associated with the project.

The surety provider assures the project owner that the contractor will perform a contract by completing specified work to a specified standard. Terms can also include assuring that the contractor adheres to specific regulations or will pay certain labourers, subcontractors and suppliers associated with the project.

If the contractor fails to perform the work as specified, the surety company is responsible for ensuring the project is completed. The surety provider offers this assurance based on its assessment of the contractor, combined with its expertise in both the financial and hands-on aspects of the construction industry. The contractor's history, capacity, financial strength, character, credit history, and a host of other factors are considered before a bond is provided.

### A Surety Review of Contractual Terms

If a project is well within a contractor's surety facility limits, within the "typical" work scope of that contractor, and with a known owner whom the contractor has worked with before, a surety may not require a full review of the construction contract and its terms and conditions. However, depending on the project size, duration, type and/or owner (i.e., private owner), the surety may require a full review of the contractual terms (including any supplementary conditions), as well as an understanding of the contractor's risk mitigation approach to certain contract risk areas.

The reason a surety may require a review and understanding of the contractor's approach to contract risk is because should the contractor (principal) be put into default by the project owner (obligee) (e.g., failing to perform the work according to the specifications or become insolvent), then the surety will assume the contractual risks of that bonded contract. Therefore, understanding the contractor's risk tolerances in the contract performance, as well as the project performance, provides the surety with additional trust and confidence in the contractor's ability to perform the contract without any significant issues and minimizes or eliminates any possible contract default (bond default). However, should there be a default, the surety is fully prepared and understands the contractual risks under the construction contract between the owner and the defaulting contractor.

An experienced surety broker is vital in the relationship between a contractor and the surety throughout the bond requirement process. An experienced surety broker can help the contractor understand some of the major contractual risk areas the surety will want to review. By having your surety broker partner working with you during the early stages of the project pursuit and help in reviewing the project and its anticipated contract requirements, the surety broker can aid you in providing a more robust submission with the proper information needed to help the surety understand the project/contract risk and the contractor's risk mitigation approach. This may help minimize (or even eliminate) the surety's questions, which will save time in being able to provide the required bond document(s), as well as help build and/or grow the surety's trust and confidence in the contractor and the contractor's project/contract risk review processes — potentially expanding the contractor's surety capacity and improving the contractor's surety terms and conditions.

This does not eliminate the contractor's obligation to utilize their legal team in the construction contract review process. Although a surety broker has experience reviewing construction contracts and a good grasp of certain contractual risk areas, a surety



broker will most likely not have a formal legal or educational background and cannot provide a good and proper legal review. The contractor's internal legal team will have the best internal understanding of that contractor's risk tolerances to be able to provide the required proper legal review of that construction contract. An internal legal review can help the contractor to determine any areas that may need additional negotiation with the owner or will need further internal and/or external risk mitigation tools of the contractor to help minimize or eliminate those contractual risk(s) well before contract signing. Examples of external risk mitigation tools include certain insurances, such as builders risk/COC and/or wrap-up liability. Examples of internal risk mitigation tools include scheduling and cost contingencies. In fact, in some cases, understanding the anticipated contractual risk profile early in the pursuit stage will help a contractor make the decision if they want to continue to spend time and money on a project pursuit or not.

## Key Contractual Risk Areas

When a surety is required to review the full contract and its terms and conditions, including any supplementary conditions, they will review the entire contract. However, there are some contract risk areas that they will put more focus on than others, and below are a few of those major contractual risk areas. Your experienced surety broker can help you understand which risk areas may be of more concern to the surety for each project requiring contract bond security so you, as the contractor, can provide additional insights on your contract risk mitigation approach and help you build a more robust submission for the broker to send to the surety for bond support.

- **Scope of Work**

- Is this the typical work scope for the contractor?
- Most contracts include a section and/or schedule attachment in the contract that provides a good understanding of the contractor's scope of work responsibilities, including those areas that are not included in the work scope.

- Watch to make sure the scope of work is not too broad so that there could be areas of a titled scope of work that are not supposed to be a part of your contract but due to the broadness of the description could be included. Make sure any areas that should not be included are noted as such in the project scope description area(s).

- **Schedule**

- Is the required schedule of performance of the work and substantial completion achievable?
  - If it is, but with extra effort, what risk mitigation have you included to help with the scheduling risk? For example, additional labour, working longer hours, pricing contingencies to cover any delay damages that may become at risk, etc.
- Are there milestone completion dates?
- Whether milestone completion dates or not, if the project has a longer project/contract length, will the owner agree to provide substantial completion for those portions of works completed well before project completion? If yes:
  - Does this include allowing the project warranty period to start at their completion times for those completed works?
  - Will they also allow early holdback release for those completed portions of work?
  - This does not change the contract bond requirement, but it does help minimize certain risks, such as warranty, etc., to both the contractor and the surety.

- **Project Size**

- Is the project size within the contractor's "typical" size?
- If on the higher side but still within the contractor's project size tolerance, the surety may require a project cost breakdown.
- If over the contractor's project size tolerance, will need more of an understanding of the

contractor's project performance approach:  
subcontractors, scheduling, contingencies, etc.

- **Type of Contract**

- Depending on the type of contract, it will put more risk on the contractor. The most common contract types are:
  - Stipulated Price/Lump Sum – Usually for construction and post-construction responsibility.
  - Construction Manager at Risk (CMAR) – This is a stipulated price/lump sum/GMP contract that includes construction management responsibility and therefore includes preconstruction stage (constructability, value engineering, contract negotiation for the construction stage, etc.) as well as construction and post-construction stages.
  - Design Build – This includes preconstruction and design responsibility as well as construction and post construction — usually the construction contractor will subcontract to a consultant or consultants for the design risk(s), however the ultimate risk belongs to the contractor (design builder) in the owner/design builder contract.

- **Payments**

- Is there an updated lien act that includes prompt payment in the place where the work is being performed? If so, then is this contract appropriately following the same regarding timing for payments throughout the project? For example: the Ontario Construction Act or the Alberta Prompt Payment and Construction Lien Act, to name a few.
- If in a province that does not yet have specific prompt payment legislation in place, are the payment terms 30 days? If not, are you as a contractor okay with the longer lead time for actual payment?
- Have you planned the project cashflow schedule to maintain your project requirements between each payment received?
- If the payment terms are a longer payment schedule than monthly (30 days) or unreasonably long, then:
  - Will you be submitting an RFI to the owner regarding this issue? And/or

- Will you have this as a qualification in your submission?

- **Law of Contract**

- This is more of a concern when the contract is with a private owner whose head office is in another country. Therefore, their contract could very well be set up according to that country's laws, not the laws where the project is located.
- You want to make sure that the contractual laws are following the laws of the place the work is being performed.

- **Owner Supplied Materials/Equipment**

- Certainly, there are benefits to having the owner take on the supply of certain materials or equipment for a project, such as eliminating the headache of the contractor having to find the appropriate supplier that meets the specific specifications of the owner, especially if an "equivalent" product is not acceptable by the owner; however:
  - There could be many of the typical controls of a contractor that are now out of the contractor's hands and/or put different contractual risks on the contractor. For instance, is the product immediately available and provided to the contractor at contract execution or at a later date? This could cause a delayed startup and/or a delayed substantial completion date, which could cause scheduling pressures, which may then lead to possible contractual disputes and bring in more contractual risk areas.
- Is the supplier contract being assigned to the contractor, or is the supplier contract staying with the owner?
  - Whether assigned or not, has the owner provided a copy of the supplier contract to the contractor for review and understanding of additional contractual risks under that contract?
- It is important to make sure, that with respect to owner-supplied materials and equipment, the contractor's construction contract risk is fair and reasonable to the contractor.

- **Owner Financing**

- Does the contract provide the contractor the ability to request evidence of the owner's project financing?
- If it does not or has been removed, does the contractor have trust and confidence in who this owner is and their financial strength to pay the contractor the project funds in accordance with the contract terms for the life of the project? This is important, especially when the owner is a private owner. Consider inserting a "private finance" clause in the bid bonds to allow for the option to view owner financing.
- Is the project size such that there may be lender involvement?

- **Dispute Resolution/Mediation**

- Is there a dispute resolution and/or mediation terms?
- Is the choice of a mediator/adjudicator by mutual agreement or one-sided?
- Is the timeline for the dispute resolution and/or mediation decision fair/acceptable?
- Who is responsible for any expenses such as attorney fees — is this reasonable and fair?
- Are you comfortable with the terms? If not, will you be clarifying your tender or submitting an RFI to the owner?

- **Hazardous Materials**

- For any unknown hazardous materials found on the site and not brought on by the contractor:
  - Is the owner fully responsible for the removal and expense of the removal of the hazardous materials, or do they require the contractor to be responsible for the removal?
    - If the contractor is to remove it, will the owner pay the contractor for the expenses to remove it?
- Does the owner provide a time extension and/or price allowance for the extra contract time in removing — whether owner removal or contractor removal?

- Does the owner indemnify the contractor against any liability due to any possible bodily injuries or for any fines levied to the contractor?

- **Indemnification**

- Is the owner and the contractor to indemnify each other, and are the indemnification terms fair/reasonable?
- Is the indemnification of the contractor limited to the contractor's negligence? (Preferred.)
- **Limitation of liability** (sometimes this is noted within the Indemnification area or as its own general condition). Is there a limit to the amount of indemnification for any losses/damages not covered by insurance? For example, the CCDC contract has a liability limit of "the greater of the contract price or \$2 million, but in no event shall the sum be greater than \$20 million" in the indemnification area.
  - Some contracts will show a contractual cap for losses/damages under the limitation of liability area of the contract — however, other limitation of liability terms will exclude the liquidated damages (LDs) so that you will have the limitation of liability amount plus LDs at risk. Sureties may be okay with this depending on contractor risk tolerance et al and the overall implications of damages/penalties and default requirement risks.
  - The limitation of liability maximum should typically not be more than the contract price and in many cases is much less.
  - See LD section for more on the limitation of liability.

- **Liquidated Damages (LD)**

- The typical type of liquidated damage is for late completion at the fault of the contractor and is a \$/day amount.
- Usually, to compensate the owner for real or "perceived" losses because of a contractor project delay (not meeting the agreed upon completion date) and/or not ready to be used for its intended purpose.
- There are some contracts that are silent on liquidated damages, and in some cases, this is okay if it is well within the contractor's scope of performing the

construction project, including time and money, with a well-known and trusted owner. However, for larger, lengthy or complex projects, and no matter the owner, having a negotiated LD amount is in the contractor's best interest so the contractor has a "predictable" and "easily quantifiable" cost risk for damages/losses.

- It is important that these LDs are worded so that these are the only damages the owner can charge for any and all types of damages and losses due to late completion.
- Is the per-day amount reasonable?
  - The per day amount is not to punish the contractor and only to provide the owner with reasonable monetary compensation for the losses and/or expenses they would have due to a late completion at the fault of the contractor. For example, certain utilities, rents, loss of revenue, financing, etc.
- Is the liquidated damage cumulative? For example, there could be LDs at multiple milestone completion dates throughout the project.
  - If so, are these cumulative or will the latter LD amount take over from the early LD amount(s).
- Is there a cap on all LDs/damages/penalties? For example, a maximum of 10% of the contract price?
  - Is the timing to reach the cap reasonable? Usually, it should take a good six months to a year to reach the cap.
  - Can the owner contractually default the contractor if the specified LD cap is reached? It's not a usual contractual default risk on its own, but it has occurred. It's not a high risk if the LD cap timing is out six months or longer.

- Is the contractor including contingencies (scheduling, price, etc.) to help minimize or eliminate any LD risk?

- **Things to watch out for:** This is very rare, but there have been contracts where there are LDs and a cap, but then there is a major risk add either within the LDs' terms or elsewhere (such as limitation of liability or other areas) that may put a major contract defaulting risk on the contractor if not properly reviewed and understood. For example:

- LDs increase over a LD milestone schedule.
- There is a 10% cap.
- How quickly will the LD cap be reached?
- If the LD amounts and cap calculation work out that the cap would not be reached until roughly six months to a year, then the contractor default risk with this may not be as a major concern as the contractor would have enough time and other risk mitigation efforts to make sure such is not reached. However, if the cap is reached quickly post substantial and there is a contract default risk attached to this, then this may be a major concern to both the contractor and the surety.

- **Mutual Waiver of Consequential Damages**

- Consequential damages relate to those indirect or special damages incurred from a breach of contract.
- Consequential damages would include such losses or damages, such as loss of profit/revenue, loss of use, loss of reputation, punitive damages, etc. It is considered an "all encompassing" term for any and all damages that cannot be properly quantified or proven.
- This is a common contractual term, which can be its own contractual general condition or be incorporated in other areas of the contract, such as Indemnity or limitation of liability areas, to name a few.
- There are some contracts that are silent on consequential damages (and the like) or are one-sided (meaning the contractor is liable to the owner for consequential damages and not vice versa).
  - If it is silent, then in some cases you as a contractor





may find this silence preferable as you may then see this as 1) an “opening to negotiation” availability for either during contract negotiation or should there ever be a time that this might become a serious discussion point in the contractual relationship, or 2) be able to use the absence of this term as a point to push back if they try to claim for these types of damages. Depending on the contractor’s strength and surety relationship, sureties may be okay with this for some construction projects that are well within the contractor’s risk tolerance.

- If one-sided, again, if the project is well within the contractor’s risk tolerance, including the project size, duration and complexity, and depending on the owner that the contractor is in contract with (i.e., public owner), then this may be considered a lower risk item to the contractor, and therefore also to the surety.
- That said, the project complexity, size or duration may make this term an important negotiated contractual inclusion.

#### • **Warranty**

- Is also be known as maintenance, guarantee or correction.
- Is the contract warranty period reasonable — one year or two years?
- Is the warranty limited to faulty workmanship, defects and deficiencies during the warranty period?
- Is there a repair/replace warranty period on those defects and deficiencies repaired and replaced during the warranty period, and if so, is it a reasonable extended term?
  - Example: Let’s say there is a project warranty period of one year. If there are any repaired/replaced works done during the one-year warranty period, then there could be an additional one-year warranty period for those repaired/replaced works only starting the date of the repair or replacement.
- Is it the responsibility of the contractor to obtain extended warranties from the warrantor(s) and hand them over to the owner? (Preferred.)

#### • **Duty of Care or Standard of Care**

- Some contracts have a specific term while others may have this embedded somewhere within the contract terms, and without including such terms as duty of care or standard of care.
- Duty of care is a common law requirement, so it may not be necessary to specifically include it in a contract, but it will be considered a part of the contract terms, nevertheless.
- Whether a specific term or embedded throughout, you want to make sure your performance is based on *reasonable care and diligence*. Any higher standard wording could put unnecessary additional risk as a professional on the contractor.
- Example wording: “... *competent professional with reasonable care and diligence in accordance with general accepted standards.*”
- If not a specific term, then all the more reason to make sure the contractor’s contractual obligations are fair and *reasonable*.

#### • **Termination**

- Termination for Cause:
  - Good idea to make them specific, if possible. If a reason is too general in wording, such as – “failure to complete obligations under contract” – this could be too generic and could mean that the owner could feel they have the right to terminate for minimal failures that could be easily corrected without the high cost, time and exacerbation of termination.
  - Does the contractor have a right to terminate for cause? For example, if the contractor has not been paid within a specific time, then the contractor can terminate for cause (nonpayment).
  - If there are any requirements of the contractor to perform certain actions/works post termination, are these requirements reasonable?
  - Owner must still pay the contractor for any accepted work performed up to termination.

- Termination for Convenience:
  - You want to make sure that this includes the payment (reimbursement) to the contractor of any purchased materials or equipment that have yet to be installed or paid for under the construction contract, as well as the outstanding contract price on accepted work performed still requiring payment from the owner.
  - Is the contractor allowed to terminate for convenience? This is a good clause to include for such reasons as if the owner has put a stop work order due to owner financing issues and the work order has gone on so long that the contractor feels they would rather just get out of the contract, then it should be reasonable to allow the contractor to request termination without cause.
    - If so, is the allowance to terminate by contractor clear in both how and timing? Time example, if a stop order is in effect for longer than 90 days, then the contractor has a right to terminate.
- **Holdback**
  - Do the holdback terms and amount follow that province's lien act/rights?
    - If not, it is important this be brought to the owner's attention and negotiate language amendments to coincide with the lien/construction act (if applicable)
  - Is there an option for early release of partial holdback? This becomes more of an option that the contractor may like when the project is larger in size and has a longer duration for project completion with portions of works completed in earlier stages of contract schedule.
- **Lien Rights**
  - Some contracts will have lien terms as its own general condition section or will be in other sections of the contract (see example in the holdback section). Another example is the CCDC 14 contract has GC Section 8.2 – Retention of Rights.
    - Are there lien rights included in the contract and following that province's lien legislation — which should mean or spell out that the contractor can lien the project without waiving their contractual rights under any other area of the contract?
    - Are the lien rights of the contractor to lien the project removed?
      - Is this due to the contract being a public/government contract? Or not being able to lien some public and government buildings or lands?
    - If not a public/government contract/construction, then the ability for the contractor to lien the project should be included in the contract terms as it is a statutory right of a contractor to have the right to lien a project, if applicable.

## Final Takeaways

The above are the primary “hot button” sections of the construction contract that surety companies will focus their energy on. Ensure you are familiar with these areas and have an experienced surety broker that can help best navigate the surety questions/concerns. Through your combined efforts, you can reduce the time spent on surety contractual questions and ensure you have minimal impact on your bids that require contract bonds. Further, familiarize your experienced surety broker with your organization's contractual risk tolerances, thereby recruiting a second set of eyes to look for contracts and contract terms that exceed these tolerance levels. Strong contract review and preparation for surety contract review questions will not only streamline your bidding process but will better manage the risks faced by your company via contract terms.

## Questions? Contact:

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