FOCUS ON GREEN BUILDING

Sustainable Buildings and the Surety

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One of the more vital, though often hidden, types of risk transfer mechanisms on many construction projects is the surety. In fact, sureties act as a basic backstop against the possibility that a project will get derailed due to the inability of a contractor or subcontractor to fulfill the terms of the contract with the owner or higher-tier contractors. Sureties allow the owner to defray his or her risk for failure of contract performance and the concomitant delays and financial difficulties that ensue. To manage risk, large and complex projects require the services that a surety bonding regime can offer, while the largest projects, including infrastructure projects, cannot even be contemplated without adequate bonding.

Because surety bonds function to guarantee the fulfillment of contract terms, they play an important role in guaranteeing building performance. Their role is increasingly implicated in the sustainable building process through either the inclusion of contract provisions for green building rating system certifications or specific attributes of building performance reasonably inferable from the contract documents to deliver sustainability. A surety is usually a large financial institution that issues a bond to assure a set of contractual obligations. In the construction context, these are most often seen as bonds to assure the performance of a contractor or subcontractor—so-called “performance bonds”—or bonds to assure the proper and timely payment of lower-tier subcontractors to prevent work delays—so-called “payment bonds.” To manage these types of performance and payment risks, almost all governmental projects on the federal, state and municipal level statutorily require the use of surety bonds as a result of the passage of the Federal Miller Act and the Little Miller Acts adopted by the states.

A surety bond is a three-party contract issued by a surety company in connection with a construction project. The three parties to the bond are the surety company, the owner and the contractor. The bond, in part, guarantees to the owner that the contractor will perform the construction project per the requirements of the contract. If the contractor fails to perform the contract, the owner may call upon the surety to step in and complete the project or correct project deficiencies. This usually occurs when the contractor does not meet the contractual requirements, performs defective work or does not have the financial wherewithal to complete a project. There are no requirements for surety bonds on private projects; however, savvy owners often require a private works contractor to procure a surety bond. This allows the owner to displace much of the financial risk onto the surety company if the contractor fails to perform.

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A LEGISLATIVE EXAMPLE AFFECTING THE SURETY INDUSTRY

Sustainable building rating systems and benchmarks have been legislated in numerous states, municipalities and counties throughout the United States. Many federal agencies also require the use of sustainable building rating systems. As sustainable building becomes fixed into the statutory and regulatory framework, the surety’s role is increasingly implicated by virtue of the fact that surety bonds are required on almost all federal, state and municipal projects. One example of legislative activity that has implicated the surety is the District of Columbia Green Building Act of 2006, which mandates the use of a surety product that does not currently exist in the marketplace.

The D.C. Act requires certain public and private projects to meet the U.S. Green Building Council’s (USGBC) Leadership in Energy and Environmental Design (LEED) certification. The D.C. Act also requires that all applicants for construction of privately owned buildings governed by the Act provide a performance bond that is due and payable prior to receipt of a certificate of occupancy. The D.C. Act sets the penal sum of the bond at an arbitrary rate of between two and four percent of the total construction price depending on the square footage of the building. The Act requires that the performance bond shall be forfeited to the District and deposited in the District’s Green Building Fund if the building fails to meet the verification requirements of the Act.

While performance bond requirements of the D.C. Act may appear benign to the casual observer, their implications may be severe for the surety industry. These problems include: 1) assumptions and vague language by the drafters which suggest that LEED is an accredited standard, possibly resulting in the interpretation of LEED as a performance standard as opposed to a prescriptive requirement; 2) failing to define the parties to the bond (a fatal error in any contract); 3) misunderstanding sustainable building rating systems that require input and control of several parties to a construction project that may or may not be in privity of contract or under the control of the contractor; 4) automatic deposit of the penal sum of the bond into a green building fund held by the District without a determination of liability or certification; and 5) determination of the forfeiture of the penal sum of the bond by the same agency responsible for verification under the Act.

From a construction risk management perspective, these problems raise several questions. How can a surety, as secondary obligor, be required to guarantee the obligation of building certification when that obligation does not lie in the hands of any one party? What effect will these obligations have upon the many parties implicated by the bond? More important, is it equitable to legislate such a performance bond requirement for automatic deposit by a surety into a green building fund held by a District administrative agency that has the authority to determine compliance with the Act’s requirements? Finally, will the District agency actually track the performance of the buildings in a meaningful manner, and if they are non-performing, what types of recourse are available to the District and the owner or developers?

This type of legislation involves a fundamental misunderstanding of the marketplace, the type of products available in the insurance and surety industry and how those products respond to today’s construction needs. Performance bonds typically guarantee the performance of a quantifiable objective. Rather than legislate a performance bond to guarantee a quantifiable goal based on an objective standard for which the bond is written, the District has chosen to legislate a particular prescriptive rating system with attendant unknown risks. The surety product will more likely end up contributing to the District’s green building fund and not the sustainable performance objectives of the District’s projects.

Owners, stakeholders, contractors, risk managers, insurers and sureties must be keenly aware of the flurry of legislative activity that may have profound and unknown affects on these industries.

TRADITIONAL RISK DRIVERS

While the D.C. Act is an unusual example of a risk that may affect a surety or insurer, there are also more common risk drivers affecting the surety industry. Right or wrong, public owners may likely look to the surety as performance guarantor of sustainable building requirements or benchmarks in the event of the bonded contractor’s default or some subsequent determination of
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non-performance. To the extent a bonded contractor defaults under his or her performance obligations on a project, such default will be exacerbated by the ill-defined performance standards of sustainable buildings. While the surety's performance liability for failed sustainable building standards and benchmarks has yet to be decided through litigation, the surety's representative should have a working knowledge of the major issues of sustainable buildings in order to address the owner's expectations.

In the surety industry, one of the greatest risk drivers that results in increased claim activity is mismatched expectations: a difference in what the owner expected to receive as a final product and what was actually delivered by the contractor. The owner and the contractor should be very clear in defining sustainability expectations, benchmarks and prescriptive requirements in the contract. This may require a collaborative effort at the outset of the project between the owner and the contractor to determine the reasons for the owner's decision to construct a sustainable building.

If the owner, for example, is primarily concerned about the marketing of the building as achieving a specific sustainable rating or complying with certain legislative rating requirements, the building's failure to meet that rating may result in claims for lost profits for building stakeholders and investors or result in statutory legal liability. Where the contract plans and specifications may incorporate rating requirements, the contractor and its surety should be careful to determine which requirements the contractor will be accountable for and which requirements fall outside the scope of the contractor's work and control.

If, however, the project owner is expecting that the use of a particular rating system will increase occupant health and productivity based on unfounded or questionable claims, the contractor should be careful that no warranties are being made with respect to those claims. Where the project owner is representing to the public and fully expects to obtain a specified level of energy savings through increased net operating income and reduced energy costs, the contractor must actively protect against unknowingly guaranteeing these performance attributes.

Public works contractors face an increasingly high demand for “sustainability” experience as federal agencies continue to incorporate sustainable building standards into federal works and as states continue to legislatively mandate sustainable building rating systems. Before embarking on a sustainable building project, it is extremely important that a contractor and its surety specify exactly what the owner is contracting for, define the responsibility of each party to the sustainable building project and determine the owner's goals—prescriptive, aspirational or otherwise—relative to the contractual requirements.

GUARANTEEING SUSTAINABLE BUILDING PERFORMANCE

Some insurers have responded to sustainability in today's market. One large insurer has issued a certified green building coverage for losses sustained to real property and assistance in the redevelopment of real property to green certification standards. The policy covers costs related to the redevelopment of those standards. Additionally, an endorsement to that green coverage provides green certification coverage for upgrades to certain business personal property and real property.

Another major insurer has created a program that provides a discount of up to 10 percent on premiums for new Pollution Legal Liability policies for properties certified under LEED.

The thought process underlying these types of policies is that buildings built to green building rating systems necessarily decrease risk. Insurers want to encourage this activity (for public perception reasons, to gain new market share and to increase premium earnings) so they offer policies that provide certain premium discounts or reinforce the use of certain rating systems. These types of policies may have their use in the building industry—undoubtedly they have been successful from a marketing perspective—but it is not clear that these rating systems reduce risk or are driven by the goal of obtaining quantifiable performance standards, increased efficiency and increased operating income through reduced energy use. While marketing has its place, an important goal of sustainable building and risk management, in part, is to increase overall efficiency, understand and mitigate attendant risks and provide a high-performance building asset.

It may be helpful for owners and their stakeholders to rethink their sustainability objectives and seek out contractual, risk transfer and project delivery options that ensure performance outcomes rather than adopting current rating systems. Incentive-based contracting using a design-build delivery system and energy performance contracting through energy service companies (ESCOs) have been used for public projects for many years. ESCOs are an important option to note since many states already have statutes governing this type of work to ensure that
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public works deliver quantifiable energy savings. In fact, many of these statutes require energy service companies to obtain surety performance bonds linked to the energy conservation measures implemented in an amount equal to the guaranteed measured and verified annual savings set forth in the underlying agreement. Other project delivery options also exist, and in all cases proper measurement and verification procedures combined with appropriate risk transfer mechanisms play a pivotal role. Such methods of establishing the benchmarks and recourse for failure should reduce the potential for mismatched expectations and allows the necessary underwriting confidence for a surety.

It is somewhat puzzling why policymakers and the building industry favor legislating building rating systems as opposed to contractually specifying performance standards. Performance contracting, for example, has been used successfully in the past, with a design-build delivery system for new construction. In this case the owner contracts with the design-builder to design and build a high-performance building. At the outset and as specified in the performance contract, the owner and design-builder set certain quantifiable sustainable performance standards. This also allows the greatest flexibility to the owner as to what areas of performance are sought depending on a full assessment of the context.

A computer model of the baseline building performance is created subsequent to a detailed building audit, and the pertinent contractually specified energy efficiency measures and targets are put into place. It is also important to incorporate into the performance contract a truly independent entity that will perform the measurement and verification. Measurement and verification are critical as are the protocols to verify performance since measurement and verification determine whether the design-builder has met the contractual obligations under the design-build performance contract.

Once the baseline and contractually specified level of energy efficiency are set along with the proper protocols for measurement and verification, an incentive could be incorporated into the design-build performance contract. To the extent the design-builder exceeds the contractually specified level of energy efficiency, the design-builder could receive from the owner a pro rata share of the energy savings up to a certain limit. The contrary also holds true. If the design-builder falls below a contractually specified level of energy efficiency, the design-builder could be penalized at a pro rata share and may be deemed to have breached its contractual obligations.

This basic illustration suggests that there are project delivery systems that provide for obtaining real and quantifiable sustainable building attributes which are tied to the performance outcome of the building. Incentive-based performance contracting with a design-build delivery system provides several advantages over legislating green building rating systems: 1) it promotes better integration between the project stakeholders; 2) it provides an incentive to the design-builders by giving them a stake in the ultimate performance outcome of the project; 3) it requires the design-builders to design and build efficiently without incorporating generic assumptions that may exist in certain rating systems and that do not further sustainability goals; 4) it promotes incentives for proper commissioning; 5) it requires clearly stated goals; and 6) it provides for accountability in the event a contractually specified energy performance standard is not obtained.

While incentive-based contracting for new construction is somewhat rare despite its advantages, energy performance contracting in existing buildings is quite common. In energy performance contracts, an energy service company (or ESCO, as noted above) will identify and evaluate energy savings opportunities in existing buildings and then recommend and, in many cases, perform existing building improvements that will be paid for by the energy savings from the improvements.

ESCOs are primarily instruments for financing building improvements and can sometimes be structured as “off the balance sheet.” It is crucial to remember that ESCOs are primarily driven by generating measurable energy savings because these provide the basis for a positive business outcome for the financing activity. Because of this, much of the due diligence for ESCO projects is to ascertain that it makes economic sense.

The ESCO will guarantee the energy savings to the owner and finance the building improvements. The owner gains building improvements that decrease operating costs, increase operating income and increase the energy efficiency of the building. The ESCO shares in the profit of those improvements through the actual savings as benchmarked to the original building energy consumption. Though ESCOs engage in performance contracting as the linchpin of their services, it is the financing that is often the most attractive attribute for owners. In addition
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ESCOs generally perform retrofit work, whereas incentive-based performance contracting is for new construction and often requires a more savvy owner and contractor to defray the risks associated with failure. For this reason, performance contracting and its more specific variant, ESCOs, are often self-insured entities.

In the context of the surety and sustainable building, ESCOs are important to note because many states already have statutes that govern this type of work to ensure quantifiable energy savings for existing public works. Many of those same statutes require the energy service contractor to obtain a surety performance bond relating to the installation of energy conservation measures in an amount equal to the guaranteed measured and verified annual savings set forth in the building program. That is, a surety bond is used to provide a secondary guarantee of a contractually specified level of energy savings based on an objective and quantified performance standard.

In contrast to the insurance policies mentioned above, which provide premium discounts for the use of rating systems or cover the additional costs for business personal property and real property to utilize rating systems, a specialized surety product could be created to guarantee the energy savings. While an insurance policy is a two-party agreement between the insurer and the insured, a surety bond is a three-party agreement between the owner, the contractor and the surety company. If a specialized surety bond were issued to guarantee the contractor’s contractual requirement to obtain a specified level of energy savings pegged to appropriate independent measurement and verification, the owner could call on the surety company to guarantee a shortfall or provide positive incentives for better-than-expected performance.

This guarantee could be monetary or the surety bond could be written to require the surety to overtake and complete the improvements to ensure the energy savings. The second option may be more valuable to the owner as the monetary value of shortfalls will likely be less than the actual cost to correct improvements to ensure energy savings.

This type of specialized surety product may also be more attractive from an underwriting perspective. If a surety were to issue a bond to guarantee the contractually specified level of energy efficiency for incentive-based design-build performance contracts, it would be clear contractually who is accountable for the energy savings (the design-builder) and what the value of the savings is (specified in the contract). The surety, therefore, could appropriately underwrite its risk, evaluate its exposure, and properly price the product in the marketplace. This type of specialized surety product would be more logical than the surety product required under the D.C. Act as it would be tied to the sustainable building performance objectives and not to an arbitrary square footage of the building.

Owners and their stakeholders may no longer have a choice due to increased or often confused legislative activity and may in fact be unfamiliar with incentive-based design-build performance contracting. Nevertheless, legislators could begin to think anew about legislating sustainability. There are many organizations throughout the U.S. that have developed accredited performance standards for sustainable buildings. These standards could be incorporated into legislation as performance standards and incorporated into public contracts whereby independent and objective third-party verifiers could measure the performance of sustainable buildings. A performance bond could be underwritten to guarantee the performance standards similar to the energy performance contract bond discussed earlier. Such legislation would not favor one particular certification system over another, would set real and quantifiable performance standards for sustainability attributes, and ultimately would guarantee performance standards of public assets through the use of a surety product.

CONCLUSION

The flurry of activity surrounding sustainability, especially as it relates to legislation and claims about the benefits of building green, cannot fail to include the industries that support the construction in this country. These industries, such as insurance and sureties, must be able to account for their risk, and provide products that support the building industry’s sustainable building goals and that can perform in the marketplace. This requires an objective examination of sustainability issues. It also requires thoughtful and creative risk management tools that view sustainable buildings as high-performance building assets with objective and quantifiable performance criteria.
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ENDNOTES

1. The penal sum of the bond is the dollar value of the bond and is the extent of the surety’s liability—on most construction projects the penal sum of the bond is the value of the contract price. See Robert Cushman and James J. Meyers, *Construction Law Handbook*, § 35.04 F(6), Aspen Publishers, 1999.