PP008 – Owner-Controlled Programs

Introduction

An “owner controlled surety program", also known as a "directed surety program”, is an arrangement under which an Obligee will appoint one Surety to issue all bonds for a particular project or group of projects, despite the fact that this designated Surety may have no direct relationship with the successful Principal. The motivation for adopting an owner-controlled surety program is the potential cost savings on bond premiums.

Background

Owner controlled surety programs were first implemented by the pipeline industry in the United States in the late 1980s and early 1990s and gained a degree of prominence in the public sector. Because of the efforts of surety and construction industry groups, Obligees have been made aware of the significant problems that can arise from using owner-controlled surety programs.

SAC Position

The Surety Association of Canada (SAC) is strongly opposed to owner-controlled surety programs, as they violate the spirit of open competition in the construction industry and do a disservice to both potential Principals and the Obligee. SAC believes that a monopoly never works to the advantage of the Obligee and any savings gained on the premium side may be lost through diminished competition on contracts.

SAC offers the following suggestions:

1. Limiting Competitive Bids

In carrying out its prequalification/underwriting function, every Surety company has its own unique risk selection philosophies and underwriting approaches. By allowing only one Surety or even a consortium of Sureties to act as the gatekeeper that Surety's philosophy becomes the sole determinant as to whether or not a contractor is permitted to work on a particular Obligee’s project. Consider a qualified firm that may not meet the criteria set out by the chosen Surety, but that has a bond facility with another Surety.

This firm will be precluded from submitting a tender in an owner-controlled surety program, depriving the Obligee of a competitive bid and the firm of a business opportunity.

SAC points out that this scenario is not hypothetical. Experience both in Canada and the United States has turned up a number of examples of an owner-controlled surety refusing to write a bond for a contractor that could readily obtain one from its incumbent Surety. The impact of having fewer competitive bids could be substantial and exceed the benefits of any savings on the bond premium.

2. Strong Relationships

The very concept of suretyship embodies the principle that a Surety stands behind the Principal. A Surety company provides assurance to Obligees that the Principal is qualified in terms of financial strength and capability to carry out the project in question. A Surety's prequalification process is extensive and requires a strong relationship between the Principal and the Surety, which results in a complete and intimate knowledge of the Principal's operations. It is unrealistic to think that a Surety in an owner-controlled surety program that has no previous knowledge of a Principal can provide a proper professional prequalification. This can lead to the Surety declining a bid for an otherwise qualified Principal due to its unfamiliarity with the details of that Principal's operation and/or history. This same level of unfamiliarity could also lead to the Surety authorizing a bond for an unqualified Principal.

3. Contractor Financing

Performance bonds provide Obligees with more than just the ability to absorb the financial impact of a Principal default. On occasion, a Surety will work with an Obligee and a troubled or cash strapped Principal to prevent such a default by financing the Principal through to contract completion. This is to the Obligee's advantage as the work proceeds with no interruption and project continuity is assured. Principal financing becomes much more difficult in an owner-controlled surety program because the Surety has significantly less incentive to finance a troubled Principal compared to the Surety with a financial stake in the Principal's entire work program.

In addition, when more than one Surety is involved, appropriate and timely action is much less likely because the situation becomes complicated as the Sureties must negotiate.

Consider the scenario of a Principal that is carrying out a profitable contract for an Obligee under an owner-controlled surety program but runs into financial difficulty as a result of losses on another project. In protecting its own interest, the Surety in an owner-controlled surety program would in all likelihood refuse to extend any additional financing to the troubled Principal. The result is likely a salvageable situation deteriorating into a total default with stoppage of work and extensive delays. Whereas a traditional approach to bond procurement, may have resulted in this unfortunate scenario being prevented.

Summary

Owner controlled surety programs do not provide Obligees the best value for their money. The best way for Obligees to achieve real savings is through genuine competition that allows all qualified Principals to submit tenders accompanied by bonds provided by the licensed Surety of their choice.

Glossary of Terms

Obligee

An individual or organization in whose favour an obligation is created and to whom a bond is given.

Principal

The individual or organization that bears the primary responsibility for fulfilling the obligation under the written contract referenced in the bond and that has the duty to perform for the Obligee's benefit.

Surety

The party to a surety bond who answers to the Obligee for the Principal's default or failure to perform as required by the underlying contract, permit or law.

YOUR BONDING RESOURCE

This paper is intended to serve as a general guideline to assist members and other readers in responding to the issues discussed. Nothing contained herein should be construed as legal advice and readers are cautioned to consult with legal counsel for such advice.

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