

Show Me The Money

Collateral Security - The Surety's Leverage

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As everyone involved in the construction industry knows, the party holding the money has important leverage. That party is able to gain concessions it may not otherwise be able to obtain and is also able to reduce its risk. Collateral security is a key remedy available to a surety to gain that critical level of bargaining strength and protection. So long as the amount demanded is reasonable when compared to the surety's potential financial exposure, when properly invoked the surety's right to demand collateral security usually leaves the party obligated to respond with few options other than to comply and pay the money demanded.

A surety who assumes the risk of issuing payment or performance bonds on behalf of a principal (i.e., a contractor) will almost always require someone with assets to execute an indemnity agreement in the surety's favor. Among other things, the indemnity agreement will obligate that party to indemnify (i.e., reimburse) the surety for any losses sustained or costs incurred as a result of issuing bonds for the bond principal. Typically, that means reimbursing the surety for any sums paid by the surety to settle claims made under a payment bond and for any costs incurred in completing performance under a performance bond after the bond principal defaults.

Most indemnity agreements also include language requiring the indemnitor to pay collateral security to the surety. Understanding collateral security begins with understanding that a demand for collateral security is not a claim for damages; the obligation to furnish collateral security is distinct and separate from the obligation to indemnify. When a surety sues under an indemnity agreement and the Court grants an award for indemnification, the surety obtains the right to the payment of money which becomes its property. However, the payment of collateral security is different in a fundamental way. Specifically, most indemnity agreements provide that the surety becomes entitled to require the indemnitor to pay collateral security when claims have been asserted under bonds issued by the surety or if the surety deems it necessary to establish a reserve to pay potential claims. The surety is in the position to invoke that right when the bond principal defaults by failing to pay suppliers or sub contractors or by failing to perform under the contract at issue. Once collateral security is deposited with the surety, the money is held in trust for use by the surety to resolve claims or to reduce expenses caused by the bond principal's defaults. In the event the amount of damages actually incurred by the surety is less than the collateral security it holds, the excess security is to be returned to the indemnitor. In other words, the purpose of collateral security is only to offset losses and eliminate risk. There is no windfall for the surety.

The fundamental difference between indemnification and collateral security (a difference which is often confused) can put the surety in a very strong position in the event it needs to sue to enforce its right to collateral security. For example, like any other claim for contract damages, one defense to an indemnification claim is that the surety has failed to mitigate its damages - i.e., that the surety has failed to take reasonable steps to reduce its losses. However, since a claim for collateral security is not a claim for damages, mitigation arguments are simply not applicable. And the fact that the surety may ultimately be completely successful in avoiding payment of claims made under the bonds it issued is completely irrelevant. What matters is the potential for financial loss caused by the bond principal's default.

In the absence of bad faith on the surety's part, the Courts have not hesitated to enforce the surety's right to collateral security. Once the surety is put in the position of having to incur the expense and bear the risk of loss involved in defending claims resulting from the bond principal's default, the Courts usually direct the payment of collateral security and limit their inquiry to the reasonableness of the amount of security demanded. In doing so, the Courts recognize that the economic incentives motivating sureties — to keep costs to a minimum — are an adequate safeguard against excessive or invalid expenditures, and also recognize the important function which sureties serve in the construction industry.