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Out With the Old, In With the New: An Overview of Construction/Surety Industry Trends in 2020 — What We Can Expect in 2021 and Beyond

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As 2020 comes to a much anticipated close and we approach the one-year anniversary of the start of the global COVID-19 pandemic, it is worth reflecting on the impacts the health crisis has had on the construction marketplace and surety industry and its likely lasting effects in the years to come. As we grappled with these issues from a legal perspective over the past nine months and surveyed our industry colleagues on their thoughts about how the world has (or hasn't) changed, some clear themes and trends in our collective thought processes emerged:

The Year in Review

Earlier this spring, many feared the worst. The possibility for nationwide and even global lockdowns prompted concerns that building activity would grind to a halt and that some industry business sectors, whether it be owners, contractors, sureties or insurers providing subcontractor default or business interruption coverage, would be left bearing the brunt of the anticipated losses. In speaking with our construction/surety industry colleagues, many expressed cautious optimism that the overall economic impact of the pandemic in 2020 will be less severe than initially projected. However, most expect the new realities presented by the pandemic will shape innovation, risk, and opportunity well into the future.

Although the response to the COVID-19 pandemic by the private sector and the government did not cause a complete halt to construction activity, the long-term effects of the pandemic have been slowly taking their toll and the effects are ongoing. The Associated General Contractors of America (AGC) reports that, with the recent "second wave" of COVID-19, projects have been pushed out or cancelled. In fact, 88 percent of firms surveyed with revenues of $500 million or more face postponed or cancelled projects, while 73 percent of firms with revenues of $50 million or less reported the same. Material shortages and disruption of supply chains are compounding delays on projects in progress. While 57 percent of the AGC respondents in June reported issues with materials and supplies, 78 percent of those surveyed now report supply chain delays. Further, construction employment figures, which have plagued the construction industry for years, are 65 percent lower than 2019 numbers in metropolitan areas.

The uncertainty of the pandemic's impacts on personal and business travel has also provided cause for owners and investors to pause long-term investments in future travel-oriented construction, and this has led to the shutdown of a number of high-profile, billion-dollar construction projects. For example, a number of infrastructure projects have been delayed or cancelled. The American Road & Transportation Builders Association reports that in 2020, approximately $9.6 billion in projects have been delayed or cancelled. Sixteen states have cancelled or postponed projects valued at about $5 billion, while the remaining $4.6 billion is due to projects delayed or cancelled by local governments.

Despite these project delays/cancellations and work slowdowns/suspensions, just as the concern that construction activity would grind to a complete halt in 2020 did not materialize, there has not been any reported significant increase in surety claim activity directly attributable to the pandemic, as some initially expected. This appears to have been due, at least in part, to the fact that project participants have been able to negotiate equitable sharing arrangements for the additional costs caused by the stay at home orders and work shut-downs in the form of delays, reduced productivity, and health and safety compliance costs. However, the long-term impacts of the ongoing construction delays, construction employee shortages, and delayed or cancelled future construction projects may very well result in increased surety claims in 2021. With an eye toward a possible near-term uptick in claims activity, many sureties have been more cautious in their underwriting and active in tracking and measuring the progress of active bonded projects.

Renewed Emphasis on Traditional Surety Best Practices

Strong Underwriting Practices Remain the First Line of Defense for the Surety

The new challenges faced by constructors have caused many sureties to more closely scrutinize the financial condition of bond applicants and the financial viability of proposed construction projects. The traditional "Three C's" of surety bond underwriting (capital, capacity and character) remain of paramount importance to the underwriting process, and, of course, well-capitalized, historically-successful, reputable contractors remain the most creditworthy type of bond applicants.

In light of the number of construction projects suspended or deferred due to the pandemic, many contractors are faced with a significant backlog of work. These backlogs are beginning to adversely impact the aggregate bonding capacity of midsize and smaller contractors in particular. The perennial problem of a shortage of skilled construction labor has not improved during the pandemic and new COVID-related supply chain disruptions mean that the availability of adequate supplies of materials is also more uncertain than in recent years. The tried-and-true solution to obtaining scarce labor or materials – paying more for them – continues to narrow contractors' profit margins, and this problem is compounded by the new and sometimes unforeseen costs that can be presented by legally-mandated compliance with new pandemic-related health and safety rules. Contractors are facing increased costs for personal protective equipment, increased on-site sanitary facilities, and reduced productivity due to social distancing measures requiring fewer workers to be present in a given section of a job site. Sureties, too, are being faced with these risks where they are asked to step in and complete a project.

As a result, increased attention is being given in underwriting new bonds to the principal's working capital, job costs, and the terms of the bonded contract itself. The importance of evaluating bond applicants' financials is underscored by the fact that, according to the American Bankruptcy Institute, this year is on pace to become the second-highest year for bankruptcies across all segments of the economy since 2009, when the nation was in the throes of the last financial crisis. The terms of the bonded contracts typically dictate which party is on the hook for labor and material cost escalations and the costs of complying with new health and safety regulations, and, therefore, sureties are taking a closer look at important risk-shifting contract provisions during the underwriting process. The contract provisions attracting the most attention are those related to time and increased compensation (or lack thereof) for delays – force majeure clauses, suspension provisions, and termination provisions.

Familiar Risk-Shifting Contractual Provisions Are Attracting Renewed Attention

Contractual force majeure and contract work suspension provisions have taken on a whole new level of importance in light of the pandemic. Traditionally understood to cover unforeseen events such as proverbial "acts of God," or other, more mundane, human-caused events that are outside the reasonable control of the parties to a contract, force majeure provisions are now being interpreted as applicable to epidemics, pandemics, and local government health and safety orders, even where these events are not expressly described in the contract. However, no uniform rule has emerged across the country to answer the question of whether or not a given contractor may be exposed to liability for pandemic-related delays if its contract does not contain a broad force majeure clause, or the clause is silent as to pandemics, epidemics or government shut downs for which COVID-19 may be the cause.

New questions also have arisen with respect to typical suspension and termination provisions. Many standard form suspension clauses allow a project owner to suspend a project without increasing the compensation due to the contractor for mobilization and cost escalations. Adding difficulty to the performance of a constructor's work by requiring it to perform at a later date without compensation for unanticipated cost increases of course carries with it associated risks to its surety. These include the risk of liquidated or other delay-related damages, in some cases in amounts large enough to push already cash-strapped contractors toward insolvency. Contractors operating under pre-pandemic suspension provisions without a baked-in right for compensation increases frequently have only general force majeure or claim submission clauses as a basis for recovery of time and cost increases due to such suspensions. How these arguments for additional time and compensation due to COVID-19 interruptions will fare in the courts largely remains to be seen.

Although not tied to the current pandemic, a decision earlier this year by the Civilian Board of Contract Appeals (CBCA) related to another recent viral outbreak demonstrated that, absent explicit contractual entitlement to additional compensation, recovery can be an uphill battle. In *Pernix Serka Joint Venture v. Department of State,* CBCA No. 5683 (April 22, 2020), the claimant sought to recover additional compensation from the Department of State concerning a 2013 project for the construction of a rainwater capture and storage system in Freetown, Sierra Leone, which construction was temporarily shut down by the contractor in August 2014 due to the Ebola virus outbreak. The parties' contract included a force majeure clause providing that the contractor would be allowed time, but not additional costs, for excusable delays, which included epidemics. Prior to the work stoppage, the government had advised the contractor that the contractor was solely responsible to decide whether work on the project should continue and how the work should progress in order to maintain the health and safety of worksite personnel.

The contractor temporarily stopped the work and brought claims for increased compensation for the costs incurred due to the additional life safety and health costs, disruption of work, and the need to maintain a safe work site as a result of the local Ebola outbreak. The CBCA rejected contractual and equitable theories advanced by the contractor and held that the subject fixed-price contract obligated the contractor to perform and receive only the fixed price. Further, because the contract explicitly stated that acts of God, epidemics, and quarantine restrictions would entitle the contractor to additional time, but not additional costs, the CBCA strictly applied these provisions and held that the contractor could not now shift the risk of additional performance costs to the government owner, observing that the government did not explicitly *order* the contractor to take any action in response to the Ebola epidemic. *Pernix Serka Joint Venture v. Department of State* illustrates the difficulty facing contractors in litigating claims to recover for additional costs due to COVID-19 under existing, pre-pandemic suspension provisions.

One obvious strategy for avoiding such results in the post-COVID era is for sureties to insist that their principals include entitlement to an equitable cost adjustment for delays or suspensions in both the force majeure and suspension provisions of their bonded contracts. Such entitlements would preclude a principal from being left "holding the bag" in the event of these kinds of unexpected work disruptions or costs. Some ambitious contractors are even seeking to negotiate for termination rights of their own in the event that an owner-directed suspension drags on for too long, or the unavailability of labor and materials due to COVID impacts makes performance impracticable. Contractors may also wish to consider including material adverse change (MAC) and/or material adverse event (MAE) provisions in their construction contracts, similar to those used in the financial and real estate sectors, which would permit contractors to terminate performance if certain significant negative financial changes affecting owners occur, such as insolvency or bankruptcy. Bonded contracts containing such rights certainly would help mitigate unexpected cost and scheduling impacts, along with owner insolvency risks.

Other Developments in the Surety Industry

Another emergent trend in the surety industry has been an increased push for the industry to modernize its approach to document management and execution. This trend has been accelerated by the shift to digital document management that those in the construction industry have been prompted to undertake by the increased need for social distancing, remote work and minimization of hard copy documents and records. Even prior to the current pandemic, with the increasing prevalence of relatively recent digital innovations like Building Information Modeling (BIM) and the increased use of digital project records management databases by owners, contractors and design professionals in the construction industry, the surety industry was perceived by some to have lagged behind in adopting new digital technologies. This may be due, at least in part, to the existence of longstanding industry norms and legal requirements such as using original, wet ink signatures on multi-party agreements and having powers of attorney signed and notarized in-person to allow for the notary to affix his or her embossed seal.

The impacts of COVID-19 have, of necessity, eased sureties' once strict requirements for paper formalities. As was recently discussed by Larry LeClair of the National Association of Surety Bond Producers (NASBP) in a recent webinar entitled "What the Election Results Mean for Construction," to comply with stay-at-home orders, Federal Agencies including the General Services Administration, Department of Defense and the Small Business Administration, took action to allow sureties to use electronic signatures in lieu of manual signatures, eliminating the requirement of corporate seals and/or notarization. While electronic signatures may be a first step, the path to truly paperless bonding requires more.

As was recently discussed by the Surety Association of Canada (SAC) and commented on by NASBP Chief Executive Officer Mark H. McCallum, these changes may be coming to the surety world soon as a result of the increased pressure brought about by the pandemic to modernize and adapt. The SAC reports that it has encouraged its stakeholders to expand their use of digital bonds by accepting electronic payment and performance bonds, and that owners, for the most part, have taken its advice. However, the SAC has found that there is continued confusion and resistance in the industry to adopting this innovation. For example, not all stakeholders agree on what a "digital bond" is. The confusion is somewhat understandable – a digital bond is not merely a scanned pdf copy of an original, paper, wet-signed bond, as those files are sometimes imprecisely described.

As explained by the SAC, the emerging definition of a "digital bond" involves three threshold criteria: (1) integrity of content, in that there are adequate assurances that the document received has not been changed or altered; (2) secure access, in that access to the document is restricted to those who are authorized to view or download it; and (3) verifiability/enforceability, in that there are adequate assurances that the document was duly executed and is enforceable at law. From a technical standpoint, digital bonds would be issued using a software or online service that is capable of ensuring reliability and integrity in the execution process – think of something like the DocuSign platform currently in use in other contexts in the United States. In addition to the potential cost, time, and health benefits that can result from using a digital bond execution process, digital bonds could be seamlessly integrated into the now-prevalent electronic bidding process on many public works projects to further reduce firms' investments in potentially uncompensated time during the bidding process.

The NASBP, along with the Surety & Fidelity Association of America (SFAA), appears to be among the early advocates for the adoption of digital bonds on this side of the border. These industry groups have been writing with the aim of encouraging the adoption of clear legal and technological standards for the implementation of an industry-wide, digital bonding process, and their efforts are attracting increasing notice. In light of these efforts and the new levels of urgency and interest brought about by the pandemic, it's likely that we'll hear much more about this innovation in 2021.

Cautious Optimism for the Road Ahead

Whether and when new lockdowns will be imposed by local, state or federal government, and whether these or the prior lockdowns will significantly impact surety claims activity, remains to be seen. Most analysts agree that the global construction market size is expected to shrink through the end of 2020 and start to slow in 2021, and are somewhat divided as to whether a recovery will begin in the second half of 2021 or be further delayed into 2022. In the U.S. market, these projections will be significantly impacted by whether the federal infrastructure program envisioned and campaigned upon by the incoming administration will be successfully deployed.

With Joe Biden's win in the 2020 U.S. presidential election, the prospect of a $2 trillion investment in the U.S. economy promises to potentially energize the national construction industry throughout the next four years and beyond. While on the campaign trail, President-elect Biden touted his Build Back Better plan, a national effort aimed at creating the jobs necessary to "build a modern, sustainable infrastructure now and deliver an equitable clean energy future." The Build Back Better plan involves a $2 trillion accelerated investment to be disbursed over the next four years.

While portions of this $2 trillion are slated for clean energy technology innovation, climate-smart agriculture, environmental justice, and the creation of one million new jobs in the electric vehicle auto industry, the remainder is promised to be invested in various sectors in the construction industry. The first construction sector listed as a contemplated recipient of the Build Back Better plan's funding is infrastructure, as President-elect Biden has promised to allocate funds to repair and rebuild portions of the country's infrastructure that have been described by some as "crumbling." As recently as 2017, the American Society of Civil Engineers rated the nation's infrastructure a "D+" in its Infrastructure Report Card, an assessment of the nation's infrastructure that is issued every four years, and estimated that an investment of $4.59 trillion by 2025 would be needed to improve its condition. The Biden plan takes steps to address these types of issues, and this includes not only deteriorating roads and bridges, but improvement and further creation of green spaces, water systems, electricity grids, and universal broadband. A portion of the Biden plan's $2 trillion also will be invested in public construction improving transit throughout American cities. This will involve the installation of light rail networks to improve existing transit as well as infrastructure for pedestrians and bicyclists.

The Build Back Better plan also envisions spurring construction activity in the private commercial and residential spaces. Namely, the plan intends to spur the upgrade of 4 million commercial spaces and weatherize 2 million homes to retrofit efficient appliances and windows through the funding of direct cash rebates and low-cost financing to business and home owners. Finally, the Build Back Better plan will encourage the construction of 1.5 million sustainable homes and housing units.

President-elect Biden's Build Back Better plan will likely be supplemented by the plans as set forth in the Moving Forward Act, which was passed by the House of Representatives on July 1, 2020, and awaits passage in the Senate. The Moving Forward Act, described by its proponents as a "transformational investment in American infrastructure that will create millions of jobs, take bold action on the climate crisis, and address disparities in urban, suburban, and rural communities across our country," seeks to allocate billions of additional dollars for highways, bridges, schools, and energy projects.

Assuming the incoming administration will be successful in deploying its vision to reenergize the American economy, there will undoubtedly be an uptick in underwriting activity in the surety industry. For one, the Miller Act requires that all contracts that might be awarded for the construction, alteration, or repair of any public work of the United States federal government to post bonds on contracts exceeding $100,000. For the various other infrastructure projects that will involve individual states and cities, states' Little Miller Acts and individual cities' surety bonding requirements on state and municipal projects will likely boost the demand for public project bonding in the next four years.

In Summary

2020 has been an eventful year, to put it lightly. Although it has been described as an "unprecedented" year in many respects, there are certainly past economic and historical events that have guided and continue to guide the collective response of the construction/surety industry, such as the 2008/2009 financial crisis and the early 2000's recession before that. As was the case with these prior crises, we are confident that our industry and all of the professionals who serve it will collaborate to emerge successfully and embrace new innovations and best practices that have been brought to light along the way.

We are excited to continue this conversation as we move forward together and find out what 2021 has in store!

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