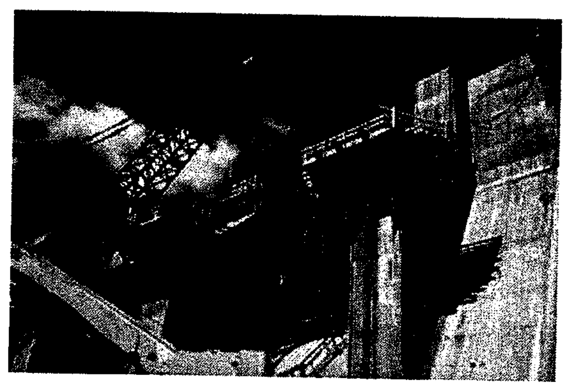
10 Things You Should Know About Surety Bonds

Making the right choice to mitigate and manage risk on construction projects and selecting the most fiscally responsible option to ensure timely project completion are imperative to a successful project – and a sound business. Gambling on a contractor or subcontractor whose level of commitment is uncertain or who could become bankrupt halfway through the job can be an economically devastating decision. Surety bonds offer the optimal solution: providing financial security and construction assurance by assuring project owners that contractors will perform the work and pay specified subcontractors, laborers, and material suppliers.

1 A surety bond is a three-party agreement where the surety company assures the obligee (owner) that the principal (contractor) will perform a contract. Surety bonds used in construction are called contract surety bonds.

2 There are three primary types of contract surety bonds. The **bid bond** provides financial assurance that the bid has been submitted in good faith and that the contractor intends to enter the contract at the price bid and provide the required performance and payment bonds. The **performance bond** protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. The **payment bond** assures that the contractor will pay certain workers, subcontractors, and materials suppliers.

3 Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms regulated by state insurance departments. However, traditional insurance is designed to compensate the insured against unforeseen adverse events. The policy premium is actuarily determined based on aggregate premiums earned versus expected losses. Surety companies operate on a different business model. Surety is designed to *prevent* loss. The surety prequalifies the contractor based on financial strength and construction expertise. Since the bond is underwritten with little expectation of loss, the premium is primarily a fee for prequalification services.

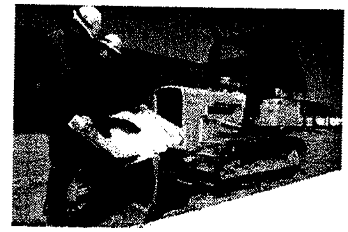


4 Since 1893, the U.S. Government has required contractors on federal public works contracts to obtain surety bonds to guarantee they will perform such contracts and pay certain subcontractors and suppliers. This law is known as the Miller Act (40 U.S.C. Section 3131 to 3134), and requires a contractor on a federal project to post two bonds on contracts exceeding $100,000: a performance bond and a labor and material payment bond. A corporate surety company issuing these bonds must be listed as a qualified surety on the **Treasury List**. Also, almost all 50 states, the District of Columbia, Puerto Rico, and most local jurisdictions have enacted similar legislation requiring surety bonds on public works. These generally are referred to as "Little Miller Acts." Owners of private construction also manage risk by requiring surety bonds.

5 Construction is a risky business. Of 853,000 contractors in business in 2002 only 610,000 were still in business in 2004 – a 28.5% failure rate. Surety bonds offer assurance that the contractor is capable of completing the contract on time, within budget, and according to specifications. Specifying bonds not only reduces the likelihood of default, but with a surety bond, the owner has the peace of mind that a sound risk transfer mechanism is in place. The burden of construction risk is shifted from the owner to the surety company.

6 Surety bond premiums vary from one surety to another, but can range from one-half of one percent to three percent of the contract amount, depending on the size, type, and duration of the project and the contractor. Typically, there is no direct charge for a bid bond. In many cases, performance bonds incorporate payment bonds and maintenance bonds.

7 The surety company's rigorous prequalification of the contractor protects the project owner and offers assurance to the lender, architect, and everyone else involved with the project that the contractor is able to translate the project's plans into a finished project. Surety companies and surety bond producers have been evaluating contractor and subcontractor performance for more than a century. Their expertise, experience, and objectivity in prequalifying contractors is one of a bond's most valuable attributes. Before issuing a bond, the surety company must be fully satisfied, among other criteria, that the contractor has:



- good references and reputation;
- the ability to meet current and future obligations;
- experience matching the contract requirements;
- the necessary equipment to do the work or the ability to obtain it;
- the financial strength to support the desired work program;
- an excellent credit history; and
- an established bank relationship and line of credit.

8 Contractor default is an unfortunate, and sometimes unavoidable, circumstance. In the event of contractor failure, the owner must formally declare the contractor in default. The surety conducts an impartial investigation prior to settling any claim. This protects the contractor's legal recourse in the event that the owner improperly declares the contractor in default. When there is a proper default, the surety's options often are spelled out in the bond. These options may include the right to re-bid the job for completion, bring in a replacement contractor, provide financial and/or technical assistance to the existing contractor, or pay the penal sum of the bond. Evidence of owners being shielded from risk is evidenced by surety companies having paid nearly $9 billion due to contractor failure on bonded projects since 1992, and half of that was paid in the last three years, according to The Surety & Fidelity Association of America, Washington, D.C.

9 When bonds are specified in the contract documents, it is the contractor's responsibility to obtain them. The contractor generally includes the bond premium amount in the bid and the premium generally is payable upon execution of the bond. If the contract amount changes, the premium will be adjusted for the change in contract price. Contract surety bonds are a wise investment – providing qualified contractors and protecting public owners, private owners, and prime contractors from the potentially devastating expense of contractor and subcontractor failure.
After analyzing the risks involved with a construction project, consider how surety bonds protect against those risks. Owners, lenders, taxpayers, contractors, and subcontractors are protected because:

10 The contractor has undergone a rigorous prequalification process and is judged capable of fulfilling the obligations of the contract;

- Contractors are more likely to complete bonded projects than non-bonded projects since the surety company may require personal or corporate indemnity from the contractor;
- Subcontractors have no need to file mechanics' liens on private projects when a payment bond is in place;
- Bonding capacity can help a contractor or subcontractor grow by increasing project opportunities and providing the benefits of assistance and advice of the surety bond producer and underwriter;
- Surety companies may prevent default by offering technical, financial, or management assistance to a contractor; and
- The surety company fulfills the contract in the event of contractor default.

For more information about surety bonding, please contact:

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The Surety Information Office is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles, and answer questions on contract surety bonds. SIO is supported by The Surety & Fidelity Association of America (SFAA) and the National Association of Surety Bond Producers (NASBP). All materials may be accessed at www.sio.org.

Surety Bonds Versus Bank Letters of Credit

Definitions

Surety Bonds

- A contract surety bond is a three-party agreement where the surety assures the *obligee* (the project owner) that the *principal* (the contractor) is capable of performing the contract in accordance with the contract documents.
- Performance of the contract, which is the subject of the bond, determines the rights and obligations of the surety and the obligee.
- A performance bond protects the owner from non-performance and financial exposures should the contractor default on the contract. It is directly tied to the underlying contract and if the contractor is unable to perform the contract, the surety has responsibilities to the owner and contractor for project completion.
- A payment bond, sometimes called a labor and material bond, protects certain subcontractors, laborers, and material suppliers against nonpayment by the contractor. Generally, these claimants may seek recovery directly from the surety company under the payment bond. It also protects the owner from these subcontractors asserting their right to file a lien against the owner's project for non-payment.

Bank Letters of Credit

- A bank letter of credit (LOC) is a cash guarantee to the owner. The owner can call on the letter of credit on demand. Once called upon, the letter of credit converts to a payment to the owner and an interest-bearing loan for the contractor.
- A letter of credit has no guarantee of project completion. The performance of the underlying contract has no bearing on the bank's obligation to pay on the letter of credit.
- A conditional letter of credit may require some burden of proof by the owner that the contractor has failed to perform before the bank will pay on the letter of credit.
- A standby letter of credit is normally used for open accounts and deals only with payment of documented sums within a stated time period.
- A transactional letter of credit applies to a specific transaction.
- Most letters of credit are irrevocable, which means that both parties must agree to any changes to the letter of credit. Changes must be documented by an amendment signed by both parties.

Prequalification

Surety Bonds

- A surety company and producer assess the contractor's entire business operation, checking for adequate financial resources, necessary experience, organization, existing workload and its profitability, and management skills to carry on the business and successfully complete the project for which the bond is required. When it issues a bond, the surety company has verified that the contractor is capable of performing the job for the stated price and in the time allotted. This process is designed to disqualify contractors who are unable or unqualified to complete the project for any number of reasons.

Bank Letters of Credit

- The banker examines the quality and liquidity of the collateral available to the bank in case there is a demand on the letter of credit. If the banker is satisfied that the contractor can reimburse the bank if demand is made upon the letter, there is no further prequalification.
- Contractors who cannot qualify for a surety bond but can provide a letter of credit may not possess all the necessary capabilities to perform the work successfully to completion.

Borrowing Capacity

Surety Bonds

- With few exceptions, performance and payment bonds are issued on an unsecured basis. That is, they are usually provided on the construction company's financial strength and experience and corporate and personal indemnity. The issuance of bonds has no effect on the contractor's bank line of credit and in some instances, can be viewed as a credit enhancement. Unused borrowing capacity can be viewed as an off-balance sheet strength.
- Subcontractors and material suppliers may be more willing to provide labor and supplies to the contractor when they are protected by a payment bond.

Bank Letters of Credit

- Specific liquid assets are pledged to secure bank letters of credit. Bank letters of credit diminish an existing line of credit, and are reflected on the contractor's financial statement as a contingent liability. Having assets tied up, or an available line of credit diminished, is counter-productive to both the owner and contractor. The contractor's cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected when liquid assets are pledged to a bank or the bank reduces its borrowing capacity as a result of the issuance of a letter of credit.
- Subcontractors and materials suppliers may be reluctant to provide labor and supplies to the contractor since they have no access or rights to funds available from the letter of credit.

Duration

Surety Bonds

- Surety bonds remain in force for the duration of the contract plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.

Bank Letters of Credit

- A letter of credit is usually date specific, generally for one year. Letters of credit may contain "evergreen" clauses for automatic renewal, with related fees.

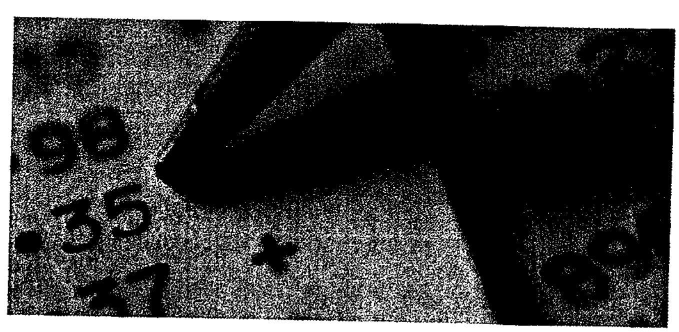
How to Obtain

Surety Bonds

- When a construction project owner specifies a surety bond in the construction contract, the contractor is responsible for obtaining the bond. Most surety companies issue bonds through knowledgeable surety bond producers, also called agents or brokers. Members of the National Association of Surety Bond Producers (NASBP) are especially qualified to assist contractors with their bonding needs. A list of surety bond producers is available at www.nasbp.org/bond.cfm.

Bank Letters of Credit

- The contractor obtains the letter of credit through a banking or lending institution.



Cost

Surety Bonds

- Generally ½ - 2% of contract price for contractors with an established bonding program. The premium usually includes 100% of contract value for the performance bond, 100% of contract value for the payment bond, plus a one-year maintenance period.
- The bond premium is included in the contractor's bid price.

Bank Letters of Credit

- Cost is generally 1% of the contract amount (usually 5% - 10%) covered by letter of credit—e.g. if LOC covers 10% of contract, Cost = 1% X (10% X Contract Amount) X years of contract.
- The cost of the letter of credit is included in the contractor's bid price to the project owner.

Coverage

Surety Bonds

- 100% performance bond of the contract amount.
- 100% payment bond protects certain subcontractors, laborers, and materials suppliers and protects owner against liens.
- Before paying, the surety investigates claims for payment, verifying their validity.
- At least 10% coverage for maintenance of defects the first year after completion.

Bank Letters of Credit

- The letter of credit may be obtained for any percentage of the contract, but 5% to 10% is typical.
- No protection/guarantee that subcontractors, laborers, and materials suppliers will be paid in the event of contractor default. They may file liens on the project.
- The owner must determine which claims are valid and must cover any shortfalls for project completion.

Claims

Surety Bonds

- The surety company has obligations to both the owner and the contractor. If the contractor and owner disagree on contract performance issues and the owner declares the contractor in default, the surety must investigate the claim.
- The surety has several alternatives to respond should the contractor be in default:
  - Finance the original contractor or provide support necessary to allow the contractor to finish the project;
  - Arrange for a new contractor to complete the contract;
  - Assume the role of the contractor and subcontract out the remaining work to be completed; or
  - Pay the penal sum of the bond.
- With payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers.

Bank Letters of Credit

- The bank will pay on a letter of credit upon demand of the holder. The holder or beneficiary must make a demand prior to the expiration date. No funds are available after the expiration date, even for liabilities incurred prior to expiration. There is no obligation to complete the project.
- There is no completion clause in a letter of credit. The task of administering completion of the contract is left to the owner.
- The owner must determine the validity of claims by subcontractors, laborers, and materials suppliers. If there is not enough money from the letter of credit to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.

International

Surety Bonds

- Surety companies are writing more contract surety bonds overseas as they gain recognition as a more comprehensive coverage to guarantee completion of construction projects within the term of a contract.

Bank Letters of Credit

- Currently, more commonly accepted overseas. Some foreign project owners may not accept a surety bond.

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The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

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The National Association of Surety Bond Producers (NASBP) is the international organization of professional surety bond producers and brokers. NASBP represents more than 5,000 personnel who specialize in surety bonding; provide performance and payment bonds for the construction industry; and issue other types of surety bonds, such as license and permit bonds, for guaranteeing performance. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.

Surety Companies:

What They Are & How To Find Out About Them

Contract surety bonds guarantee the performance or financial obligations of others. In construction, contract surety bonds are provided to an *obligee* (for example, the construction project owner) by licensed surety companies that commit their assets to support the performance and financial obligations of the *principal* (typically the contractor). General contractors frequently also act as the obligee in the case of bonds provided by subcontractors. Surety bonds used in construction include bid, performance, and payment bonds as well as supply and maintenance bonds. Construction owners, contractors, lenders, public officials, and others involved in the construction project need to know about the companies that issue surety bonds and the role of the surety bond producer.

What Is a Surety Company?

Most large property and casualty insurance companies have surety departments. In addition, there are some insurance companies for which surety bonds make up all or most of their business. In either case, in order for a company to write a surety bond in the United States, it must be licensed by the insurance department of one or more states in which the surety conducts business.

The surety company's thorough prequalification process greatly reduces the likelihood of contractor default. The surety company underwriter takes an in-depth look at the contractor's entire business operations—credit history and financial strength, experience, equipment, work in progress, and management capability—and must be satisfied that the contractor is capable of completing the project before issuing a bond. Should the contractor experience difficulties on a project, the surety company may elect to assist the contractor to head off default. In many cases, the owner may not even be aware of the surety's involvement.

In the unfortunate event that the owner declares the contractor in default, the surety must investigate the claim, analyze all options, and choose a course of action. If the contractor is in a default situation, the surety may finance the original contractor or provide support to ensure project completion, arrange for a new contractor to complete the project, rebid the job, or pay the cost of completion up to the penal sum of the bond, depending on the options in the particular bond form.

Information about surety companies can be obtained from The Surety & Fidelity Association of America (SFAA), (202) 463-0600; www.surety.org. SFAA represents the majority of companies that write surety and fidelity bonds in the United States.

Other sources of information about surety companies include:

- State Insurance Departments;
- U.S. Department of the Treasury;
- Ratings Organizations; and
- Surety Bond Producers.

State Insurance Departments

State insurance departments license companies that write surety bonds and can provide information on these companies. The insurance department of the state in which the surety company is domiciled is responsible for performing periodic examinations of the company and usually will have the most information about a surety company. Insurance departments usually are located in state capitals and may have offices in other large cities of the state. Sources for locating a state insurance department are:

- The state government listing in the local telephone directory; or
- The National Association of Insurance Commissioners, www.naic.org/state_web_map.htm.

U.S. Department of the Treasury

A surety that wants to write bonds for federal government construction projects must have a certificate of authority issued by the U.S. Department of the Treasury. The Treasury Department conducts a financial review of the surety and sets a single bond size limit for the surety. The Treasury Department maintains a list of surety companies that it has qualified to write surety bonds on federal government projects.

Treasury Department Circular 570: Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and as Acceptable Reinsuring Companies is published in the *Federal Register* on July 1 each year. A free copy of the most current "Treasury List" may be accessed at www.fms.treas.gov/c570/index.html.

Ratings Organizations

A.M. Best Company is a private company that analyzes and rates insurance companies. Each year it publishes *Best's Insurance Reports, Property-Casualty*, which includes detailed profiles and financial information on almost every insurance company operating in the United States. Best's gives each company an alphabetic rating and a financial size category (the rating pertains to the entire insurance company and not just the surety operation). This book is available in many public and financial libraries or may be purchased from A.M. Best.

The A.M. Best Company also publishes an abbreviated version of the information in its *Best's Key Rating Guide, Property-Casualty*, which contains only the alphabetic ratings and financial size categories of each insurance company. A.M. Best will not distribute information to inquirers who do not subscribe to either publication, nor will they divulge ratings information over the telephone. Up-to-date information and prices on Best's publications are available at www.ambest.com.

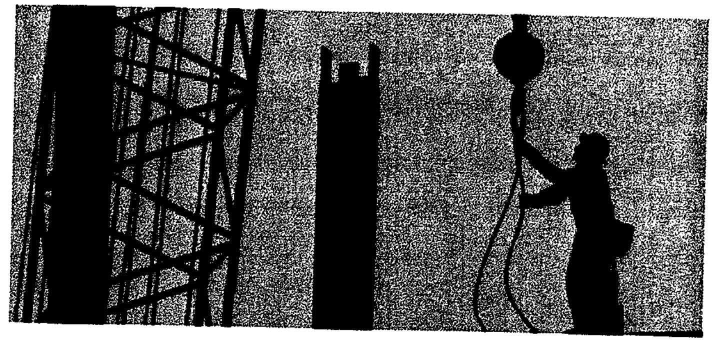
Other ratings organizations include:

- Dun & Bradstreet (www.dunandbradstreet.com/us),
- Fitch Ratings (www.fitchratings.com),
- Moody's Investors Service (www.moodys.com),
- Standard & Poor's (www.standardandpoors.com/), and
- Weiss Ratings Inc. (www.weissratings.com).

What Is the Role of a Surety Bond Producer?

Most surety bonds are issued through surety bond producers (or agents) who are knowledgeable about the surety and construction industries. Surety bond producers work in agencies that specialize in surety bonds or in insurance agencies that have a sub-specialty in surety bonds. The professional surety bond producer maintains a business relationship with several surety companies, which enables the producer to match a contractor with an appropriate surety company.

The surety bond producer assists a contractor in obtaining surety bonds, and provides business advice,



management consulting, and technical expertise. The producer is an integral part of the contractor's external advisory group, which may also include attorneys, lenders, and CPAs. By using specialized knowledge of the construction industry, the producer assists the contractor in preparing for the surety company's rigorous prequalification process. As a contractor develops a strong business relationship with a surety bond producer, a relationship will also develop between the contractor and surety company. A good surety company and surety bond producer can help a contractor maintain and increase its surety capacity.

Contact information for producers specializing in surety bonds can be obtained from the National Association of Surety Bond Producers (NASBP), (202) 686-3700; www.nasbp.org/bond.cfm. NASBP members adhere to professional standards that demonstrate professionalism, expertise, and innovation in surety bonding.

Surety Bond Authenticity Program

The Surety & Fidelity Association of America (SFAA) maintains a list of surety companies that will assist in verifying the authenticity of a surety bond and the fact that the surety authorized the execution of the bond.

For a free copy of the list of participating surety bond companies, send a self-addressed envelope to The Surety & Fidelity Association of America, 1101 Connecticut Avenue NW, Suite 800, Washington, DC 20036. The authenticity program also is available at www.surety.org (select "About the Industry," then "Bond Authenticity Program").

When making an inquiry directly to a surety company on SFAA's list to authenticate a bond, the following information should be provided:

(The best way to supply this information is to enclose a photocopy of the bond with your inquiry.)

1. Bond Number (if any)
2. Name and address of principal [contractor or subcontractor] (include names of all parties if the principal is a joint venture)
3. Name and address of the obligee [owner or general contractor]
4. Amount of Performance Bond
5. Amount of Payment Bond
6. Date bond executed
7. Name of person signing bond for the surety
8. Brief description of project
9. Contract price
10. Name and address of person to whom the confirmation of authenticity should be sent.

Please allow sufficient time for the surety to respond.

This brochure is not intended to be all-inclusive, but merely to provide some commonly accepted sources of information.