



*Contract Surety Bonds:
Protecting Taxpayer Dollars*



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Contract Surety Bonds: Protecting Taxpayer Dollars

Construction is a complicated and risky enterprise—even capable and well-established contractors fail. For more than 100 years, schools, cities, counties, states, and the federal government have successfully managed risk and protected taxpayer dollars with bid, performance, and payment bonds.

I. PURPOSE OF SURETY BONDS: FINANCIAL SECURITY & CONSTRUCTION ASSURANCE

Surety bonds provide financial security and construction assurance to public project owners by assuring that contractors are qualified to perform the contract and will pay certain subcontractors, laborers, and material suppliers.

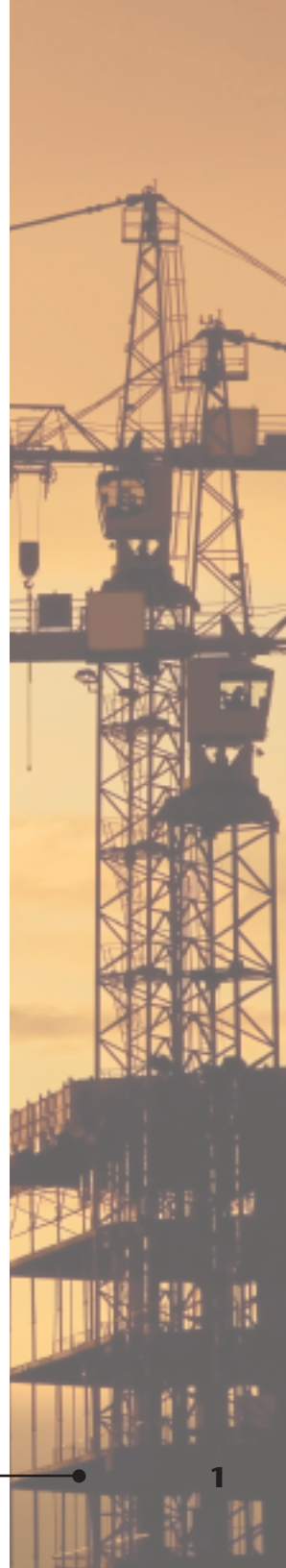
Most public works contracts are awarded under a competitive, sealed, open competition bidding system where the work is awarded to the lowest responsible bidder. Surety bonds are especially important in the low-bid system to protect taxpayer dollars from irresponsible bidders and incapable contractors.

When a contractor obtains performance and payment bonds, the risk of contractor failure is transferred to the surety company.

II. WHAT ARE SURETY BONDS?

Surety bonding is a three-party relationship among the owner, contractor, and surety. A contract surety bond is given to the public owner by the construction contractor to secure the performance of a construction contract (the performance bond) and to assure that certain labor, materials suppliers, and subcontractors will be paid (the payment bond). The surety company and its financial resources stand behind the contractor, enabling the contractor to enter into a contract and protecting the public project owner from contractor default.

A contractor contacts a professional surety bond producer to obtain the necessary bid, performance, and payment bonds. The bond producer helps the contractor develop a business relationship with a surety company, guides the contractor through the bonding process, and assists in managing the contractor's surety capacity.





Bid Bond

The bid bond assures that the contractor intends to enter into the contract at the price bid and will provide the required performance and payment bonds. The bid bond is the basic instrument of prequalification, which means the surety has investigated the contractor's entire business operations and deems it qualified to perform the contract. The bid bond's purpose is to screen out unqualified contractors from bidding on a project.

Performance Bond

The performance bond is a binding obligation of the contractor and surety for the performance of the contract or payment of the cost of performance, up to the amount of the bond. It protects the public entity and taxpayers from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. Before contractors can obtain a surety bond, they undergo a rigorous prequalification process, called underwriting, to determine whether, in the view of the surety, they are capable of performing a given contract. Performance bonds usually include a one-year maintenance period to cover correction of defects from faulty materials or workmanship.

Payment Bond

The payment bond assures that certain subcontractors, laborers, and material suppliers will be paid in the event of contractor default.

III. HISTORY OF SURETY BONDS

A Long History of Protection

The first known account of contract suretyship was etched on a Mesopotamian clay tablet around 2750 B.C. A farmer contracted with another farmer to tend his fields and split the proceeds equally. A local merchant served as the surety and guaranteed the second farmer's

compliance. A millennium later, in the first known written legal code, Hammurabi addressed suretyship. A Babylonian contract of financial guarantee from 670 B.C. is the oldest surviving written surety contract, and the Roman Empire promulgated surety law around 150 A.D. that survives in the principles of suretyship today.

Protecting the Public

Today, surety bonds protect almost every public construction project across the country. Annually, nearly \$300 billion in nonresidential public works projects are under construction throughout the United States with surety bonds providing valuable protection against contractor failure.

IV. WHY ARE BONDS REQUIRED?

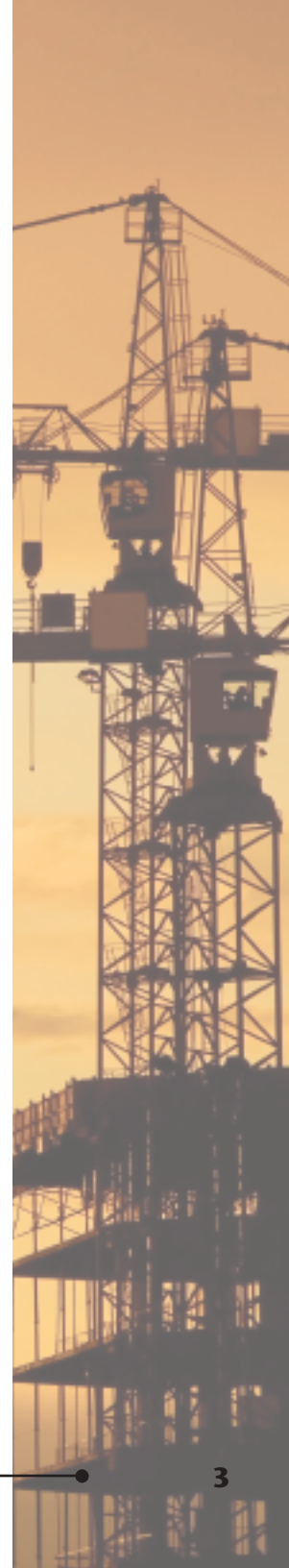
While suretyship has a long history, it wasn't until the 19th century that corporate surety bonds were used. Recognizing the need to protect taxpayers from contractor failure, Congress passed the Heard Act in 1894, which required surety bonds on all federally funded projects. Even prior to the Heard Act, government contracts and contracting officers required these bonds, but there was no statutory requirement.

The Miller Act of 1935 was the first major change in public sector surety and is the current federal law mandating surety bonds on federal public works. The Miller Act, as amended, requires performance and payment bonds on federal public works contracts exceeding \$100,000. In addition, payment security for subcontractors and suppliers must be provided on federal construction contracts between \$30,000 and \$100,000 pursuant to Federal Acquisition Regulations. A payment bond is among the alternative payment protections included in the FAR. The Miller Act requires:

- A **performance bond** with a surety satisfactory to the officer awarding the contract, and in an amount the officer considers adequate, for the protection of the Government.
- A **payment bond** with a surety satisfactory to the officer for the protection of all persons supplying labor and material in carrying out the work provided for in the contract for the use of each person. The amount of the payment bond shall equal the total amount payable by the terms of the contract unless the officer awarding the contract determines, in a writing supported by specific findings, that a payment bond in that amount is impractical, in which case the contracting officer shall set the amount of the payment bond. The amount of the payment bond shall not be less than the amount of the performance bond.

For a company to write a surety bond in the United States, it must be authorized to conduct surety business by the insurance department of one or more states. Generally a surety company must be licensed in the state in which it is doing business or by the state where the obligation guaranteed by the bond is being performed.

A corporate surety company issuing bonds on federal construction projects must be listed as a certified surety on the Treasury List, which the





U.S. Department of the Treasury issues twice each year. The T-List, as it is known, is available online at www.fms.treas.gov/c570/c570.html. All 50 states, the District of Columbia, Puerto Rico, and most local jurisdictions have enacted “Little Miller Acts” requiring surety bonds on their own public works projects.

V. HOW SURETY BONDS WORK

The fundamental concept of contract surety is that contractor default is preventable. Unlike traditional insurance, which is designed to compensate the insured against unforeseen adverse events, surety companies underwrite to prevent loss. The surety prequalifies the contractor based on its financial strength and construction expertise. Surety companies spend a great deal of time and expense in the underwriting process to qualify a contractor before issuing a surety bond. If the surety does not have confidence that the contractor can perform the contract, it should not issue a bond. As a result, the underwriting effort keeps contractor defaults to a minimum.

Each surety company has different underwriting standards and may specialize in different markets. If denied bonding by one surety company, a contractor may apply for bonding with other surety companies.

Learn More

For more information on contract surety bonds, see SIO’s brochure, *Importance of Surety Bonds in Construction* and SIO’s CD, *Surety Bonds: A Guide for Public Construction*

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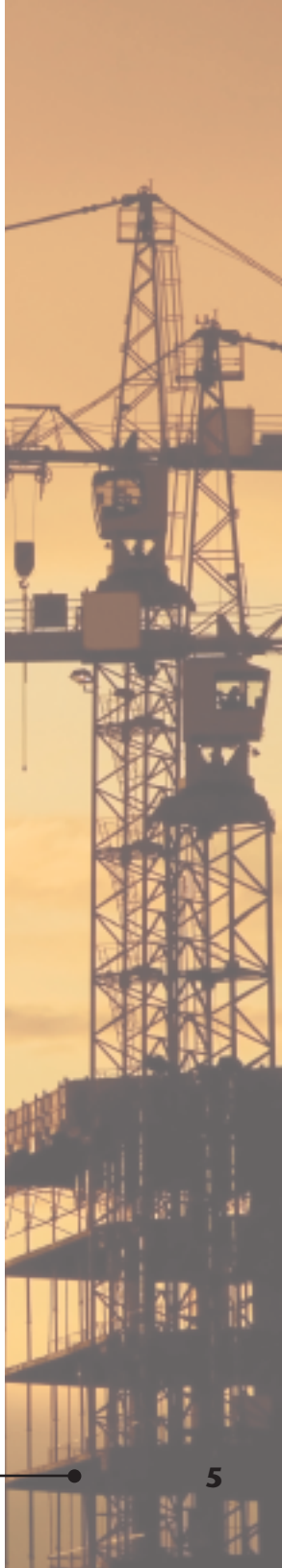
Since surety companies back the contractor’s bond with their own corporate assets, they conduct careful, professional, and rigorous prequalification reviews of contractors. The surety company and bond producer have access to detailed financial information; ongoing analysis of the contractor’s strengths and weaknesses; and information on past, current, and future work. They maintain ongoing relationships with contractors and have a comprehensive understanding of contractors’ work programs. Surety companies and professional surety bond producers have been evaluating contractor and subcontractor performance for more than a century and possess the expertise, experience, and objectivity to effectively prequalify the contractor.

Most surety companies require indemnity from the contractors and subcontractors they bond. This may include personal indemnity of the construction company owners in addition to the guarantee of the contracting entity. A bonded contractor or subcontractor is more likely to complete bonded

Surety Bonds	Traditional Insurance Policy
<ul style="list-style-type: none"> • Regulated by state insurance departments 	<ul style="list-style-type: none"> • Regulated by state insurance departments
<ul style="list-style-type: none"> • Prequalification intended to prevent loss 	<ul style="list-style-type: none"> • Spreads fortuitous losses among a large group of similar risks
<ul style="list-style-type: none"> • Three-party – Principal (contractor) obtains bond from surety that protects the Obligee (owner). Owner ultimately pays for bond 	<ul style="list-style-type: none"> • Two party (insurer, insured) – Coverage purchased by the insured protects the insured
<ul style="list-style-type: none"> • Coverage is project specific 	<ul style="list-style-type: none"> • Coverage usually term specific, renewable
<ul style="list-style-type: none"> • Bond forms standard or may be negotiated by owner and surety or contractor 	<ul style="list-style-type: none"> • Policy forms vary by insurance company
<ul style="list-style-type: none"> • Coverage 100% of the contract price for performance, 100% for payment, up to penal sum of bond 	<ul style="list-style-type: none"> • Coverage up to policy limit
<ul style="list-style-type: none"> • Claims – Surety has right to contract balance and indemnity from contractor (contractor remains primarily liable) 	<ul style="list-style-type: none"> • No right to insured's assets, however, companies can subrogate against a third party or another insurer
<ul style="list-style-type: none"> • Bonds are required by law and voluntarily by private owners 	<ul style="list-style-type: none"> • Buying insurance is a voluntary way of managing risk of loss for the insured

jobs because business assets, and possibly personal assets, are on the line. Should the contractor default, the contractor remains primarily liable to

complete the construction contract, so the right of indemnity is the surety's protection against losses it may have to pay in the event of a default.





Prequalification—An In-depth Analysis of the Contractor

The underwriter looks at all aspects of a contractor's business including:

Financial Strength

- Annual and interim financial statements
- Investment strategies
- Cost control mechanisms
- Work in progress (bonded and non-bonded)
- Cash flow
- Evidence of a line of credit at the bank and credit history
- Net worth
- Working capital
- Bank and other credit relationships
- Financial statements for three to five years

Ability to Perform

- Completed projects and profit, over five years
- Equipment
- Organizational chart with employees' resumes
- Past, current, and future work (bonded and non-bonded)
- Continuity plan
- Geographic areas where work is performed
- Business plan with growth and profit objectives
- Management plan

Reputation With

- Project owners
- Subcontractors
- Suppliers
- Lenders

VI. SUBCONTRACTORS

Benefits of General Contractor Bonds

Subcontractors deserve the protection of a payment bond. Without a payment bond, if the general contractor fails to pay them, many subcontractors may risk the viability of their

businesses – no matter how qualified they are. Mechanic's liens cannot be placed against public property, thus the payment bond may be the only protection these claimants have if they are not paid for the goods and services they provide. Even if the owner has already paid the contractor for the subcontractor's work, if the contractor does not in

turn pay them, the subcontractors and suppliers have the right to make a direct claim on the payment bond. On federal projects, the public agency must provide a copy of the bond to subcontractors and suppliers upon receipt of an affidavit by the claimant stating that the claimant has supplied labor or materials and has not received payment.

Benefits of Subcontractor Bonds

Subcontractors can have a significant impact on a construction project's successful outcome. Subcontractors who are unable to perform can bring a construction project to a halt, particularly if the subcontractor is responsible for a significant portion of the contract or is a specialty contractor that is difficult to replace. Because the contractor is ultimately responsible for completing the contract, subcontractor failure places the contractor at risk for failure as well. Many prime contractors (and their sureties) consider a policy of bonding subcontractors a sound business practice.

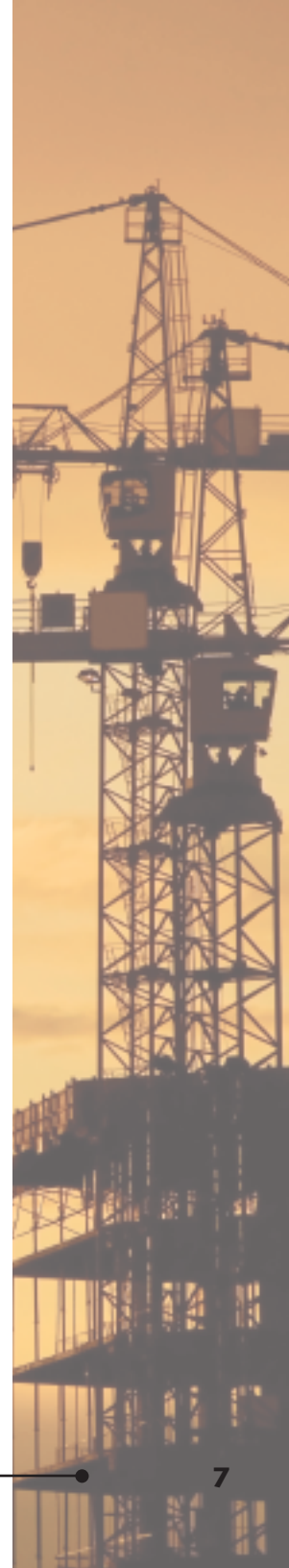
VII. COST OF SURETY BONDS

The cost of a performance bond is a one-time premium, which typically ranges from 0.5% to 2% of the contract amount, depending on the size and type of the project and the contractor's bonding capacity. There is often no charge for the bid bond, and the payment bond may be issued at no additional charge when issued in conjunction with a performance bond.

The Myth of Double Bonding

When a contractor requires its subcontractors to obtain performance and payment bonds, the contractor is seeking the same type of protection against subcontractor failure as an owner does when it requires surety bonds of the contractor. The bonds that the prime contractor provides to the owner are for the owner's protection and provide no protection against subcontractor default. Prime contractors require bonds of their major subcontractors and suppliers for the same reasons—to avail themselves of the prequalification services of the surety and to transfer risk of subcontractor or supplier failure.

The contractor pays the bond premium upon receiving the bond, whether construction has begun or not. The bond premium is included in the bid as it is considered part of the cost of construction. In most cases, the project owner pays the contractor for the bond premium in the first construction draw. If the contract amount changes, the premium will be adjusted for the change in contract price. Payment and performance bonds typically are priced based on the value of the contract being bonded, not on the size of the bond.





VIII. COST OF CONTRACTOR FAILURE

When compared to the cost of contractor failure, surety bonds are a low-cost investment considering the protection provided. Thousands of contractors, whether they have been in business for two years or 100, large and small, fail each year, leaving behind unfinished construction projects with billions of dollars in losses to project owners. According to BizMiner, one in five contractors fail. The Surety & Fidelity Association of America (SFAA) reports that sureties have paid over \$10.5 billion on contract bond claims since 1995. Over \$8 billion of that was paid to complete and pay subcontractors and laborers on federal, state, and local projects.

Learn More

For information on causes of contractor failure, see SIO's brochure, *Why Do Contractors Fail?*
www.sio.org

IX. CLAIMS PROCESS

Default is an unfortunate, and sometimes unavoidable, circumstance of construction. Once notified of a default, the surety owes duties to both the contractor and the project owner. The surety company independently investigates notices of disputes or claims and provides the project owner and contractor with its assessment.

The surety will conduct an investigation to determine:

- The contractor's and the owner's contractual obligations;
- Whether the contractor has defenses against the declaration of default; and
- If the owner has met its obligations under the contract.

Learn More

For claims case studies, see SIO's booklet, *Surety Bonds at Work*

www.sio.org

For information on the claims process, see AGC's booklet, *An Overview of the Contract Surety Bonds Claims Process*

www.sio.org

Obligations of the Project Owner

- Review the contract documents. Establish terms of the agreement, provide clear explanation of the contractor's obligations, and define what constitutes default;
- Provide the contractor with a high-quality working set of plans and specifications;
- Pay the contractor on time;
- Maintain adequate insurance;
- Communicate with the surety company to inform it of progress and any potential problems; and

- Notify the surety company of changes in the contract.

If the surety's investigation finds that the contractor has defaulted on the project under the performance bond, the surety may take one of the following actions, depending on the bond form and the specific facts of the case:

- "Take Over" responsibility for completing the remaining work. The surety hires a completion contractor.
- "Tender" a new contractor to the obligee.
- Retain the original contractor and provide technical and/or financial assistance.
- Reimburse the owner by paying the cost of completion, up to the penal sum of the bond.

If the investigation reveals that the contractor is not in default, the surety company is not obligated to perform.

Learn More

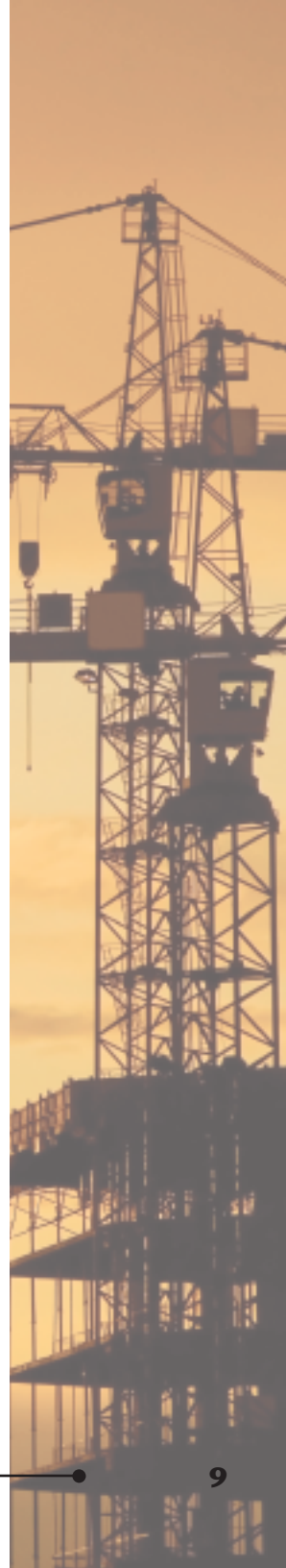
For information on how to qualify the surety, see SIO's brochure, *Surety Companies: What They Are and How to Find Out About Them*
www.sio.org

There are things project owners can do to manage the process:

- Verify the validity of the bond before awarding the contract;

- Notify the surety of changes in the contract;
- Know who to contact at the surety company;
- Notify the surety as soon as problems on the project are recognized;
- If possible, allow the contractor time to cure the default before termination;
- If default occurs, notify the surety company in writing and ask for a specific response;
- Be reasonable and diligent in providing notice of default;
- Request a face-to-face meeting to discuss the complaint; and
- Provide records and correspondence to the surety company.

The expectations of the parties involved in a claim are not always the same. The owner wants its project completed and to be compensated for all losses resulting from contractor default. The contractor may believe it was wrongfully terminated or that some of the cost to complete should be the responsibility of the owner. The surety is trying to determine its obligations and determine the best way to satisfy them. Everyone involved in the default should understand the rights and obligations of the other parties and be prepared to work together to resolve areas of dispute. It may not be easy, but it is necessary to





School District Fails to Verify Contractor's Bonding

A school district's failure to ensure that a construction company was properly bonded on three new schools proved to be a costly mistake.

The district properly stipulated that the contractor obtain a surety bond, but apparently no one double-checked that the contractor actually obtained the bond before work began. "Somebody did not make sure the i's were dotted and the t's were crossed," an executive at the local contractors association told a community newspaper.

Subsequently, at least a dozen subcontractors were not paid when the contractor ran into financial trouble and went out of business, and the district may bear the burden—more than a half million dollars. Ultimately, the courts will have to decide, as some subcontractors seeking payment have

filed civil lawsuits against the district and the contractor for breach of contract and negligence.

"This was a huge mistake," a project manager for one of the subcontractors suing the district for more than \$100,000 told the newspaper. "We have to pay our bills or else we're dead in the water."

What's more, the district was required to hire a new contractor to complete unfinished work on the school projects. Had the contractor properly secured a surety bond for the public works projects as it was required to do, the surety company would have been responsible for paying the subcontractors and completing the projects. And, if the contractor hadn't qualified for surety bonding in the first place, it wouldn't have been awarded the job.

ensure successful project completion. The surety's investigation takes time, so be reasonable in your expectations of what the surety will provide. If the surety is not responsive, contact the state insurance commissioner's office.

X. PUBLIC POLICY ISSUES

Public contracting agencies may have the best of intentions when they waive bonding

requirements, seek an increase in bond thresholds, or bundle multiple projects together under one contract, but these efforts typically have unintended and adverse consequences.

Bond Waivers

When a public entity waives bonding requirements, it may be to save the expense of the bond premium to reduce project costs or allow more contractors to bid on the project. Waiving bonds may be a

violation of federal or state laws that make surety bonding a requirement. The surety's independent third party prequalification is more thorough and more economical than a project owner's, who would have to maintain a staff or hire a consultant for this purpose. The phrase, "penny wise and pound foolish" comes to mind when a public entity waives the bond requirement. Allowing unqualified contractors to bid on a project does not increase competition, it puts qualified, bondable contractors at a competitive disadvantage.

Bonding requirements exist to provide:

- Contractors who are qualified to complete the project;
- 100% of the contract value for project completion should the contractor default;
- Protection against defective materials and workmanship;
- A safeguard of taxpayers' dollars;
- Financial recourse for subcontractors and suppliers if they are not paid; and
- Insulation to public and elected officials from the politics of the bidding process. Bonding allows the public agency to accept the low bidder, knowing he or she is qualified to perform the project.

Learn More

For information on why bonds are required, see SIO's paper, *Why Bid, Performance & Payment Bonds Are Required For Public Construction Projects*

www.sio.org

Bond Thresholds

As stated earlier, under the federal Miller Act, Congress requires a payment and performance bond for 100% of the contract price for projects in excess of \$100,000. In addition, the federal law requires "payment security" for all contracts between \$30,000 and \$100,000. A surety bond is one of the options for providing such payment security.

All 50 states and the District of Columbia require surety bonds on state and local public works projects. The state bond thresholds vary, but the majority of states have thresholds of \$50,000 or less. Some states mirror the federal government's \$100,000 threshold, and only a few states have thresholds exceeding \$100,000.

When state legislatures consider raising bond thresholds, it usually is done to reflect the effects of inflation on the cost of construction. State and federal governments must decide at what level they need to protect their agencies and taxpayers. Some entities may feel that if they have not experienced any defaults on a bonded





project that bonding is not necessary. Others claim surety bonds add costs and complexity to construction projects. In some cases, raising bond thresholds is intended to advance small and emerging contractors by allowing more to bid on public construction business.

The absence of contractor defaults can be misleading, as one of the most significant benefits of bonds is that sureties prequalify contractors prior to the bidding process. A minimum number of defaults demonstrates that the surety's assessment of the contractor was correct—the contractor was capable of performing the contract.

Then, consider the cost of not bonding. Because of the interdependent nature of construction, sometimes contractor failure is unavoidable. Financial issues, management issues, unrealistic growth or overexpansion, and uncontrollable events such as the economy, labor shortages, or weather can cause problems for even large, established contractors. The billions of dollars sureties have paid in public and private construction losses over the past 25 years further reflect the inherent risk of construction. Raising bond thresholds would allow more contracts on which state and local jurisdictions would bear the burden of re-letting work and paying excess completion costs. This can be problematic on projects with tight budgets or schedules.

A contractor's ability to obtain bonding reflects his or her capability to perform a

contract. Higher bond thresholds potentially allow more contractors who are incapable of obtaining bonding and who have not been through the surety's comprehensive vetting process to bid on and be awarded large public contracts for which no payment and performance bond would be required. This exposes public entities to greater risk, gambles with taxpayers' money, and burdens subcontractors with the possibility of nonpayment.

As for advancing small and emerging contractors, increasing bond thresholds does not necessarily mean that these contractors would obtain more public construction business. Instead, it could result in financially unstable contractors who could not obtain bonding and who were not prequalified by a surety bidding on and winning public construction jobs. Perhaps worse, those small and emerging contractors acting as subcontractors on those projects would not have the protection of a payment bond should something go wrong with the general contractor.

Learn More

For information on bonding emerging contractors, see SIO's brochures *Helping Contractors Grow: Surety Bonding for New & Emerging Contractors* and *SBA's Surety Bond Guarantee Program*

www.sio.org

Furthermore, increasing bond thresholds may do more harm than good if the goal is only to advance small and emerging contractors. To grow in the arena of public construction, a contractor needs an established relationship with a surety. Increasing the level at which the contractor is first required to seek bonding delays the inevitable bonding requirement if the contractor wants to expand. The later the small contractor is required to enter the bonding world, the harder it will be to gear its business to meet a surety's underwriting standards. These underwriting standards also help ensure that the contractor is taking the steps necessary to manage his or her business correctly and efficiently. In the long run, raising bond thresholds harms small and emerging contractors and suppliers by substantially increasing their risk of nonpayment if they are operating as subcontractors and by raising the difficulty of qualifying for their first bonds.

Project Bundling

Some public works owners are grouping multiple construction projects—including ones that may be completely unrelated—under a single contract. These public owners may be “bundling” projects because they have limited project management resources. However, in their attempt to prevent stretching their resources too thin, these public owners may inadvertently be putting untested management teams on projects that are much larger than what they have worked on before.

While some projects may be well-suited for bundling, generally it makes sense to keep individual projects separate, and even break larger contracts into several smaller projects. The larger a public construction contract grows, the fewer contractors exist that are capable of performing the work and the more surety capacity these contractors will need to be able to bid on the contract. Not all contractors qualify for surety bonding, and only the better managed, well-capitalized firms have access to bonding capacity large enough for mega projects. And those who do qualify for significant bonding capacity may not wish to allocate all of that capacity to a single project. Bundling projects limits the number of bidders who can compete for the job, and with fewer bidders, public owners may not receive the best contract price.

It also is easier to spread risk over multiple projects with multiple contractors than on one big project. Extremely large projects (over \$500 million) likely will require co-surety arrangements and joint ventures to spread risk.

In addition to receiving the best contract price possible, many public works owners need to meet set-aside goals, such as awarding a certain percentage of contracts to minority contractors. Bundling projects is counterproductive to these primary goals since few minority contractors are large enough to perform these contracts.





SIO

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