For more information about contract surety bonds, please contact the:

SIO

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The information source on contract surety bonds. SIO is supported by The Surety Association of America and the National Association of Surety Bond Producers.

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SAA represents approximately 650 member surety companies and 10 foreign affiliates that underwrite surety bonds.

NASBP

National Association of Surety Bond Producers (NASBP)
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NASBP is an international organization of and for professional surety agents and brokers. NASBP is comprised of more than 5,000 personnel who specialize in providing surety bonding to contractors and subcontractors.

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Surety Bonds Versus Bank Letters of Credit

Issues	Surety Bonds	Bank Letters of Credit
Definitions	◆ A contract surety bond is a three-party agreement whereby the surety guarantees to the obligee (the owner) that the principal (the contractor) is capable of performing the contract. ◆ 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.	◆ A bank letter of credit (LOC) is a cash guarantee to the owner. The owner can call on the letter of credit on demand without cause. 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 one 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	◆ A surety company and producer assess the contractor's entire business operation, checking for adequate financial resources, necessary experience, organization, existing work load 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. Contractors who cannot qualify for a surety bond but can provide a letter of credit may not possess all the necessary ingredients to perform the work successfully to completion.	◆ 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.

Issues	Surety Bonds	Bank Letters of Credit
Borrowing Capacity	◆ With few exceptions, performance and payment bonds are issued on an unsecured basis. That is, they are usually provided on the strength of corporate and personal signatures of the owners of the construction company. 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 extend credit to the contractor when they know a payment bond has been issued on a project to protect them.	◆ Specific 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 or credit. ◆ Subcontractors and materials suppliers may be reluctant to extend credit to the contractor for labor or materials since they have no access or rights to funds available from the letter of credit.
Duration	◆ 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.	◆ 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	◆ 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. Contact NASBP at (202) 686-3700; nasbp@nasbp.org for a list of surety bond producers.	◆ The contractor obtains the letter of credit through a banking or lending institution and includes the cost of the letter of credit to the owner in the contract bid price.
Cost	◆ Generally ½ to 1% of contract price for contractors with established bonding credit. The premium includes a 100% performance bond, 100% payment bond, plus a one-year maintenance period. ◆ The bond premium is included in the contractor's bid price.	◆ Cost is generally 1% of the contract amount covered by letter of credit—e.g. if LOC covers 10% of contract: Cost = 1% x (10% x Contract Amount). ◆ The cost of the letter of credit is included in the contractor's bid price.
Coverage	◆ 100% performance bond of the contract amount. ◆ 100% payment bond protects certain subcontractors, laborers, and materials suppliers and protects owner against liens. ◆ At least 10% coverage for maintenance of defects the first year after completion. ◆ Before paying, the surety investigates claims for payment, verifying their validity.	◆ 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 event of contractor default. They may file liens on the project. ◆ The owner must determine which claims are valid.
Claims	◆ 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: 1. Finance the original contractor or provide support necessary to allow the contractor to finish the project; 2. Arrange for a new contractor to complete the contract; 3. Assume the role of the contractor and subcontract out the remaining work to be completed; or 4. Pay the penal sum of the bond. ◆ With payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers.	◆ 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 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.	◆ Currently, more commonly accepted overseas. Some foreign project owners may not accept a surety bond.