What Are Surety Bonds?

A surety bond is a promise to be liable for the debt, default, or failure of another. It is a three-party contract by which one party (the surety) guarantees the performance or obligations of a second party (the principal) to a third party (the obligee). Therefore, when a surety company issues bonds on behalf of a prime contractor in favor of the owner, the prime contractor is the principal; and the owner is the obligee. When a surety company issues bonds on behalf of a subcontractor in favor of a prime contractor, the subcontractor is the principal; and the prime contractor is the obligee.

What are the categories of surety bonds?

There are two broad categories of surety bonds: (1) contract surety bonds, which are bonds directly associated with construction projects; and (2) commercial (also called miscellaneous) surety bonds. Commercial surety bonds cover a very broad range of bonds that guarantee performance by the principal of the obligation described in the bond. They are required of individuals and businesses by the federal, state, and local governments through various statutes, regulations, and ordinances. For instance, most construction contractors are required to obtain a contractor's license bond through a state licensing agency, which covers those obligations set forth in the applicable state licensing statute.

Are surety bonds like traditional insurance policies?

No, surety bonds are very different from traditional insurance policies. Both surety bonds and traditional insurance policies, such as property insurance, are risk transfer mechanisms regulated by state insurance departments. However, traditional insurance is a two-party agreement designed to compensate the insured against unforeseen adverse events. The policy premium is actuarially determined based on aggregate premiums earned versus expected losses. Surety companies operate on a different

business model. Surety bonds are three-party agreements designed to prevent a loss. The surety does not "assume" the primary obligation but is secondarily liable, if the principal defaults on its bonded obligation.

The surety views its underwriting as a form of credit, much like a lending arrangement. For contract surety, for instance, the surety will examine in-depth the contractor's credit history and financial strength, experience, equipment, work in progress, management capacity, and character. After the surety assesses such factors, it makes a determination as to the appropriateness and the amount, if any, of surety credit.

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Thus, if the surety extends surety credit to a contractor, the surety does not expect to suffer losses because the surety expects the bonded contractor to perform its obligations successfully AND the surety has a signed indemnity agreement from the contractor to protect it from any losses. The general agreement of indemnity, or GIA, is a contract between a surety company and a contractor. The GIA is a powerful legal document that obligates the named indemnitors to protect the surety from any loss or expense the surety suffers as a result of having issued bonds on behalf of the bonded principal. A surety company almost always requires that the principal, the individuals who own and/or control the company, their spouses, and often affiliated companies to sign the GIA before it will issue bonds on behalf of the contractor.

What are contract surety bonds?

Surety bonds that are written for construction projects are called contract surety bonds. A project owner (the obligee) seeks a contractor (the principal) to fulfill a contract. The contractor, through a surety bond producer, obtains surety bonds from a surety company. If the contractor defaults, the surety company is obligated, pursuant to the performance bond, to find another contractor to complete the contract or compensate the project owner for the financial loss incurred. In addition, through the payment bond, the surety ensures that certain subcontractors and suppliers are paid for labor and materials, which is also an indirect and important benefit to the owner.

What are the four types of contract surety bonds and what is the risk each transfers?

- **Bid Bond:** Primarily provides the owner a means to recover the cost of having to repeat the bidding process or the difference between the lowest bidder and the second lowest bidder when the bidder is awarded a contract but fails to sign the contract or provide the required performance and payment bonds. A bid bond does not guarantee any portion of the construction.
- **Performance Bond:** Provides the owner with a written guarantee that, in the event of a bonded contractor's default, the surety will complete the work, make funds available to finish the work, or reimburse the bond obligee for the damages arising out of the contractor's default. The penal sum of the bond is set forth in the bond itself and sets the maximum limit of the surety's liability to the obligee. The bond language, along with the statutory provisions that require bonds on public works projects, dictates the rights and obligations of the surety and the obligee. For instance, some performance bonds require the obligee to terminate the principal pursuant to the terms of the underlying bonded construction contract before the surety can be liable. Architects cannot make claims under performance bonds.
- **Payment Bond:** Ensures that certain claimants--subcontractors and suppliers--will be paid for labor and materials furnished for use in the performance of the bonded construction contract. The language of the bond itself and/or any applicable statutes govern whether a party has the right to make a bond claim. Because claimants cannot place mechanics' liens against public property, the payment bond may be the only protection claimants working on publicly funded projects have if the contractor does not pay for the goods and services provided to the project. Architects will be pleased to know that design professionals providing services can be proper claimants under certain payment bonds, depending on the specific language of the bond and any applicable statutes.
- **Warranty Bond (also called a Maintenance Bond):** Guarantees the owner that any workmanship and material defects found in the original construction will be repaired during the warranty period, typically one or two years, although it can run longer.

What are the key benefits of contract surety bonds?

The two main benefits of contract surety bonds are prequalification and financial protection. A surety will not issue bonds on behalf of a contractor until it is satisfied, through the prequalification process, that the contractor is capable of completing the bonded contract. The surety's prequalification process assures the obligee that the bonded contractor is qualified to perform the contracted obligation.

While the prequalification process makes it much less likely that the bonded contractor will default on its contractual obligations, it is not a guarantee that it will not default. If the contractor defaults on its obligation, the bonds provide a financial guarantee that the contract will be performed and that certain laborers and suppliers will be paid for work and materials furnished on the project.

When are contract surety bonds required?

Under the Miller Act, any federal construction contract valued at $150,000 or more requires a performance bond and payment bond as a condition of contract award. Each state has a "Little Miller Act," similar to the federal Miller Act, which requires a performance bond and a payment bond for state contracts over a certain amount, called the bond threshold. Most municipalities require performance and payment bonds as well.

In the private sector, there is no mandate for the use of bonds on construction projects. Understanding the value of contract surety bonds, however, many private owners require contract surety bonds on their projects for the same reasons the government does. In the same manner, as a risk management tool, prime contractors will often elect to require their subcontractors obtain performance and payment bonds. Sometimes construction lenders require bonds on projects as a condition for the owner to receive financing.

How are contract bonds priced?

Bonding typically costs 1 percent of the contract amount. The cost of a performance bond is a one-time premium between 0.5 percent and 3 percent of the contract amount. While it is the contractor (or subcontractor) that obtains the bonds, the premium is paid by the project owner, typically in the first pay request. The rates must be filed with the state insurance departments, and many companies reduce the premium amount for well-established, experienced, and financially strong firms. Premiums may be higher for newer or less capitalized firms, but sustainable small businesses with an established track record can also get lower rates.

Bid bonds typically have no fee. Payment bonds are usually issued in conjunction with performance bonds for no additional charge, and many sureties offer 100 percent coverage for both. For example, if the contract amount is $5 million, a premium of between $26,500 and $40,500 could pay for a performance bond and payment bond that provide $10 million in protection.

Do other products provide the same protection as bonds?

In a word, no. Despite claims that are often touted for other products, no other risk management product provides the comprehensive protection that performance and payment bonds provide.

For instance, a letter of credit (LOC) may offer access to a small amount of the contract value in the form of cash should the contractor run into trouble on a project; however, the task of administering completion of the contract, raising enough funds for completion, and determining the validity of subcontractor and supplier claims is left to the owner. A surety company, on the other hand, is focused on the completion of the contract and has a number of options to assure the contract is completed according to the contract terms. Also, with payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers.

Does subcontractor default insurance provide the same protections as surety bonds?

No. Subcontractor default insurance (SDI), also referred to as “Subguard” (the brand name of the product issued by Zurich Insurance), is often described and marketed as an alternative to performance and payment bonds; but it is merely a traditional insurance policy between the prime contractor and the insurance company. The insured (and the beneficiary) under the policy is the prime contractor--not the owner or the lower-tier subcontractors and suppliers.

Performance and payment bonds are a comprehensive risk management transfer mechanism that provides the prequalification of subcontractors according to established criteria, shifts the risk of the principal’s default from the obligee (owner) to the surety, and provides 100% payment protection to covered subcontractors and suppliers. Because SDI does not provide payment to subcontractors, the most vulnerable contractors (small, emerging, minority) are exposed to greater risk.

In addition, surety bonds require the surety to manage default situations. With SDI, the prime contractor is responsible for handling all aspects of a default situation. The prime must pay all losses initially and then seek reimbursement from the insurer. The effect on the principal’s cash flow can have a significant impact on the ability to complete the job and pay its subcontractors.

Does raising bond thresholds or waiving bonds help small, emerging, and minority contractors?

The goal in bonding is building sustainable contractors by allowing small contractors to build successful portfolios of bonded work. Lower thresholds allow contractors to build relationships with sureties and build capacity earlier in their careers. Raising bond thresholds increases the risk of non-payment and default, due to lack of a surety’s extensive prequalification process, during which the surety verifies that the contractor is capable of completing the contract and paying its subcontractors and suppliers.

The bonding capacity of a contractor is established and expands as a contractor grows and succeeds. If bonds are waived, the contractor never gets the thorough review of its business and does not get an opportunity to build a successful track record with the surety company. A small company will be much more likely to get support for a small project.

The later a contractor is required to enter the bonding world, the harder it will be to gear its business to meet the underwriting standards put in place to ensure only qualified contractors are bonded to complete public and private projects. In the long run, while waiving bonds might get a contractor one job, it harms small and emerging contractors and suppliers by raising the difficulty of qualifying for their first bonds and substantially increasing their risk of non-payment if they are functioning as subcontractors.

To contact a NASBP surety bond producer near you, go to the NASBP Surety Pro Locator at **suretyprolocator.nasbp.org**, a directory of NASBP professionals specializing in surety bonds.

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