



# 9 Things Savvy Owners Should Know About Surety Bonds

## Manage Risk Effectively

Surety bonds provide owners with a proven, highly effective way to transfer project risks so that construction projects are successful and business reputations are enhanced. Each year some contractors fail before they complete their projects or pay their subcontractors and suppliers. With surety bonds, the burden of construction risk shifts from the owner to the surety company, protecting the owner's investment and reputation.

## What Is a Surety Bond?

A surety bond is a three-party contract by which an authorized surety company assures the owner that the contractor will perform a contract. Surety bonds are not like traditional insurance policies; they are more like a bank credit arrangement. The surety does not expect to suffer losses, because the surety expects the bonded contractor to perform its contractual obligations successfully AND the surety has an indemnity agreement, with the contractor's personal and corporate indemnity, which protects the surety from any losses suffered as a result of having issued the bonds. Contractors performing bonded contracts are said to have "skin in the game" and are unlikely to abandon such contracts.

## Types of Contract Surety Bonds

There are three primary types of contract surety bonds. The *bid bond* assures the owner that a contractor awarded a contract will enter into that contract and provide the required performance and payment bonds. The *performance bond* protects the owner from financial loss in the event that the contractor fails to perform the contract in accordance with its terms and conditions. The *payment* bond assures that the contractor will pay certain subcontractors and suppliers on the bonded project.

## Surety Is Regulated

Most surety companies are subsidiaries or divisions of authorized insurance companies; therefore, surety bonds are regulated by state insurance departments. A corporate surety issuing bonds on federal construction contracts must be a certified surety on the U.S. Department of Treasury List, Circular 570.

## Bonds on Public and Private Contracts

Performance and payment bond requirements are a hallmark of public procurement policy. Bonds have been required on federal contracts since 1894, and the current statute, the Miller Act, enacted in 1935, requires performance and payment bonds for federal construction contracts in excess of \$100,000 (and, by regulation, \$150,000). Almost all 50 states and many local jurisdictions have enacted similar legislation, known as Little Miller Acts, requiring surety bonds on public contracts. Many owners on private construction projects also manage risk by requiring contract bonds.

## What Is the Cost of Contract Bonds?

Surety bond premiums vary from one surety to another, but generally range from 0.5% to 3% of the contract price and vary depending on the size, type, and duration of the project and the contractor, with many premiums averaging around 1%. All bond rates are filed with the appropriate state authorities and are predicated on the total contract amount, not the base amount of the bond. Typically, there is no charge for a bid bond if performance and payment bonds are required on the project.

## Prequalification of the Contractor

The surety company's rigorous prequalification of the contractor protects the owner and offers assurance that the contractor is capable of completing the project. Surety companies and surety bond producers have been evaluating contractor performance for over a century; their combination of expertise, experience, and



objectivity in prequalifying contractors is one of a bond's most valuable attributes.

Before issuing a bond, a surety company must be fully satisfied that the contractor has, among other criteria, the following:

- 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
- An established bank relationship and line of credit.

### **Bonds Are Easy to Specify**

To bond a project, the owner merely includes the requirements for bid, performance, and payment bonds in the plans and specifications for the project. 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.

### **Bonds Guarantee the Success of the Owner's Project**

Surety bonds are a major factor in ensuring project success. The owner and the project are protected because:

- The contractor has undergone a rigorous prequalification process by the surety company and is deemed capable of fulfilling the contract obligations.
- Contractors are more likely to complete bonded projects than non-bonded projects because the surety company requires personal and corporate indemnity from the contractor.
- Surety companies may prevent default by offering technical, financial, or management assistance to a contractor.
- The surety company fulfills the contract in the event of contractor default.
- The surety company guarantees certain subcontractors and suppliers will be paid for work and materials.

#### **Have more questions about surety bonds and the bonding process?**

Go to NASBP's "Answers to 32 Questions Public and Private Owners Ask About Contract Bonding," by going to [www.SuretyLearn.org](http://www.SuretyLearn.org). In addition, contact a professional surety bond producer near you with your questions. Agencies specializing in surety bonds, listed by state, can be found in the NASBP membership directory on the NASBP website at [www.nasbp.org](http://www.nasbp.org) (click on "GET A BOND").



**SURETY.**

**BE GUARANTEED TO SUCCEED.**