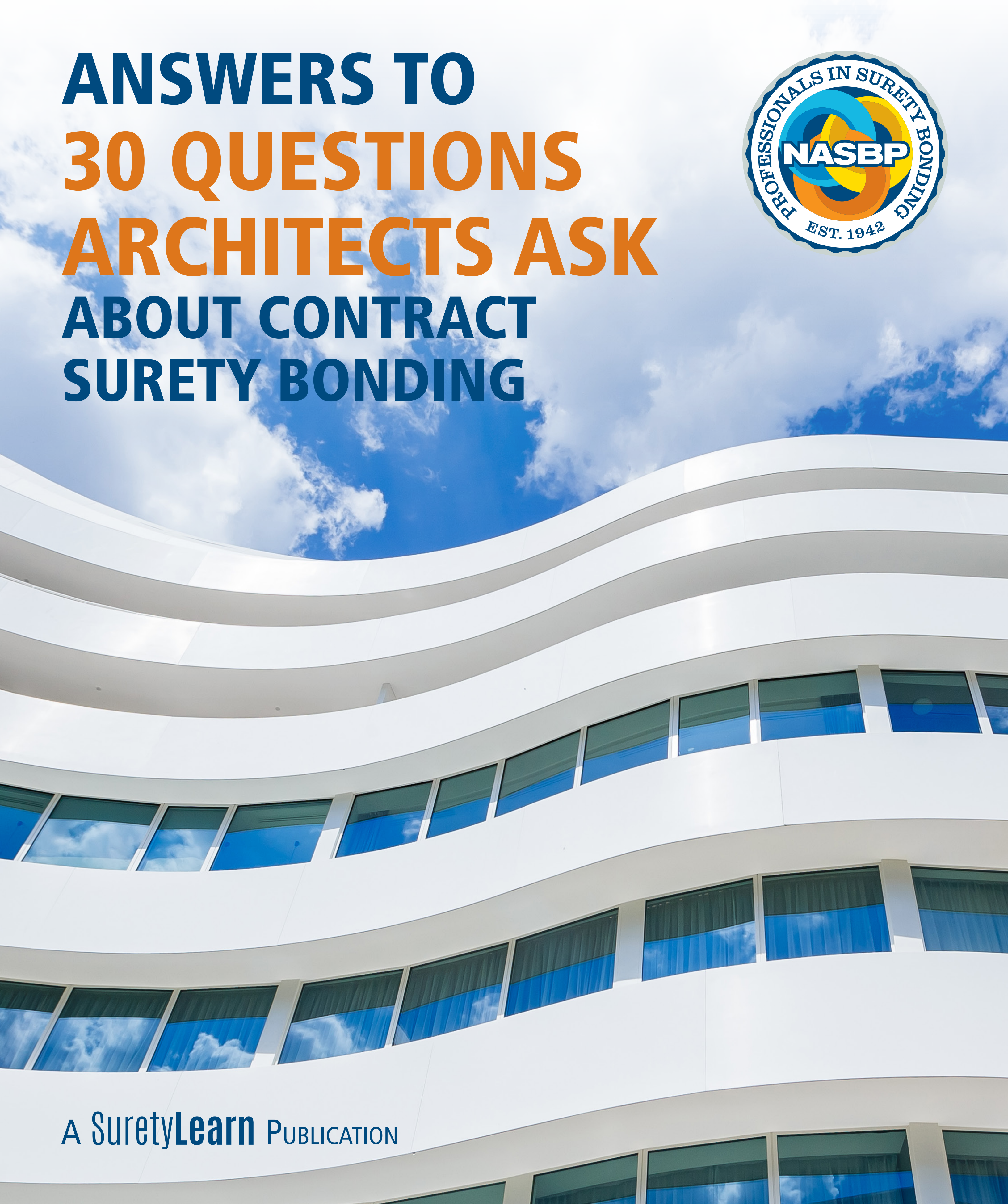
National Association of Surety Bond Producers

ANSWERS TO 30 QUESTIONS ARCHITECTS ASK ABOUT CONTRACT SURETY BONDING



A SuretyLearn Publication

ANSWERS TO 30 QUESTIONS ARCHITECTS ASK ABOUT CONTRACT SURETY BONDING

Surety bonds are unparalleled, proven risk management mechanisms that help ensure public and private owners their construction projects are built in accordance with the plans and specifications and certain subcontractors and suppliers are paid. Surety bonds help provide owners of construction projects with guarantees of success and enhanced reputations.

As owners' design consultants for and representatives on construction projects, architects have a vested interest in ensuring that their owners have the best contract risk management mechanisms in place--to protect the owner's finances, to protect the architect's own reputation, and to guarantee the successful completion of the contract itself, the goal of all construction project stakeholders.

The National Association of Surety Bond Producers (NASBP) is a national trade association, headquartered in Bethesda, MD, comprised of agencies employing surety bond producers placing bid, performance, payment, and warranty bonds on federal, state, local, and private projects in the United States and around the world.

NASBP is aware that surety bonds and the bonding process can be complex and mysterious and that many stakeholders in the construction industry, including architects, understandably have misconceptions about the nature and purpose of surety bonds. To eliminate those misconceptions for the benefit of architects and the owner/clients they serve, NASBP created this series of questions and answers that address contract surety bonds and the bonding process.

It should be noted that the Q&As below generally presume use of the design-bid-build contract delivery method. While bonds are used on projects with other delivery methods, the answer to some of the questions might be modified with the use of a different delivery method.

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

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1 As an architect, why should I care about surety bonds?

The owner's selection of an architect is a major factor in a construction project's success, and there is often a close interaction between the owner and the architect from initial schematic design through project completion. Owners seek architects who will partner with them to achieve successful projects. It is critically important that architects use their knowledge and skills to advise the owner and to facilitate the success of each owner's project.

By becoming a prized resource for clients by providing design expertise and a primary source of relevant industry information, an architect becomes a key contributor to the success of his or her client's business and vital to its operations. Owners look to architects for risk management ideas and best practices. Advice from a trusted architect includes helping the owner with information to select various risk management protocols to help ensure the successful completion of the project. Contract surety bonds are a major risk management tool for project owners, but in the design community generally, bonds are an underappreciated and often misunderstood tool for transferring risk and enhancing the potential for successful projects.

Bonds play an essential role in the construction risk management process. First, when a surety issues bonds on behalf of a contractor, that surety is providing assurance to the owner that the contractor is qualified and capable of meeting its obligations under the bonded contract. Second, bonds protect project owners against the failure or default of a construction contractor and protect certain subcontractors and suppliers against the contractor's failure to pay them for labor and materials furnished. And third, a prudent architect knows that surety bonds provide a means of completion and/or recovery when a frustrated and/or angry owner is seeking recourse for an incomplete or defaulted project.

An architect who understands the benefits of bonding construction contracts will be better prepared to advise owners that bonds can help ensure successful performance of the contract, the shared ultimate goal of every design professional and owner. Architects cannot be the ultimate expert advisor to owners concerning surety bonds, but they should encourage owners to consider their use to guarantee contracts and to seek the advice of knowledgeable construction/surety attorneys.

The following Q&As are intended to provide relevant information on bonds and the bonding process so that architects can become better prepared to advise owners on surety bonding benefits.

2 What is a surety bond?

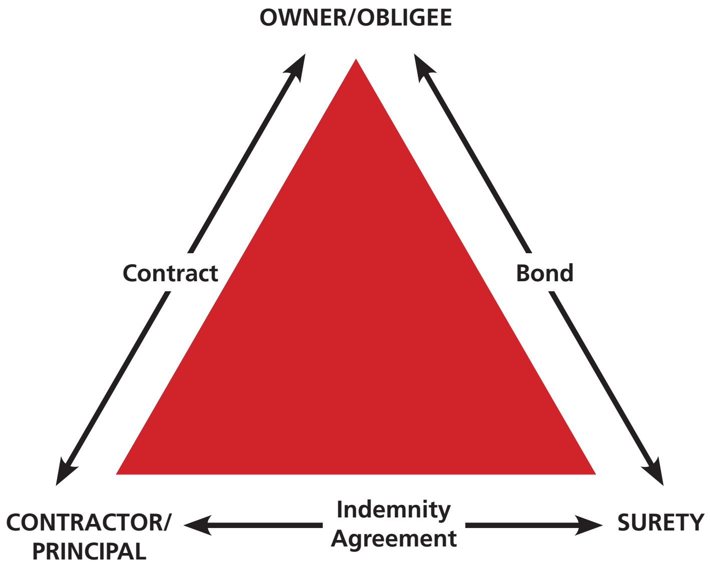
A surety bond is a promise to be liable for the debt, default, or failure of another. A surety bond is a three-party contract by which one party (the surety) guarantees the performance of a second party (the principal) to a third party (the obligee). Surety bonds that are written for construction are called contract surety bonds.

The surety is an insurance company licensed by a state department of insurance through issuance of a certificate of authority to act as a surety insurer to provide surety bonds to guarantee the performance of a principal.

The principal is the entity (in construction, the contractor, subcontractor, or supplier) that qualifies for the bond. It is the principal's obligation that the surety guarantees for the benefit of the obligee (the owner or the prime contractor).

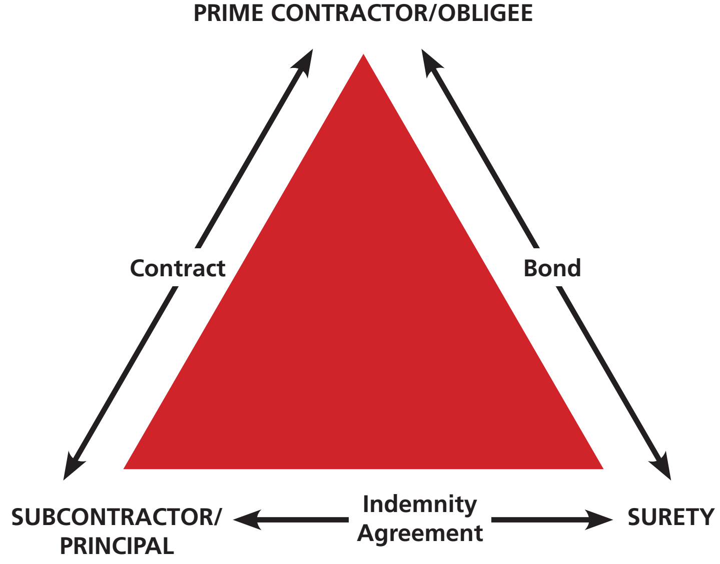
The obligee is the entity with whom the principal has a contract and to whom the bond is given. In construction this is the project owner or the prime contractor. When a surety company issues bonds on behalf of a prime contractor in favor of the owner, the prime contractor is the principal; and the owner is the obligee.

Owner as Obligee



When a surety company issues bonds on behalf of a subcontractor in favor of the prime contractor, the subcontractor is the principal; and the prime contractor is the obligee.

Prime Contractor as Obligee



3 What are contract surety bonds?

Bonds written by an insurance company for construction contracts are referred to as contract surety bonds. The main types of contract surety bonds are: bid bonds, performance bonds, payment bonds, and warranty bonds (sometimes called maintenance bonds), each of which transfers risk from the owner (or laborers and suppliers) to the surety.

The two basic functions of these bonds are:

- ✔ **Prequalification—**assurance that an independent third party, the surety, has thoroughly evaluated and determined the bonded contractor is qualified to perform the contracted obligation.
- ✔ **Protection—**if the contractor defaults on its obligation, guarantee that the contract will be performed according to the plans and specifications and that certain laborers and suppliers will be paid for work and materials supplied on the bonded project.

(Distinguished from contract surety bonds are the other main type of surety bonds: commercial surety bonds, of which there are myriad types, such as license and permit bonds, public official bonds, and probate and other court bonds.)

4 Are surety bonds like traditional insurance policies?

No. Surety bonds are almost always written by insurance companies (or divisions of insurance companies) that are licensed by state insurance departments, but they are not like traditional insurance policies. Surety bonds are three-party agreements, and traditional insurance policies are two-party agreements, such as life insurance or property insurance policies. The surety does not "assume" the primary obligation but is secondarily liable, if the principal defaults on its bonded obligations.

It is important that architects understand the difference between how surety bonds and traditional insurance policies function and to explain that distinction to owners. While an insurance company expects losses on its property and casualty policies, a surety does not expect losses under the bonds it issues. A surety does not expect to suffer losses because the surety has prequalified the contractor as capable of fulfilling the bonded contract and expects the bonded contractor to perform its contractual obligations AND the surety has a signed indemnity agreement from the contractor to protect the surety from any losses the surety suffers as a result of having issued the bonds for the principal. While the surety does not expect losses, sometimes unfortunate circumstances occur; and then the owner and laborers and suppliers have the protections of the performance bond and the payment bond.

The surety's rigorous prequalification process and the contractor's indemnification obligations to the surety offer an owner powerful risk management tools in the bonding toolbox. These are, of course, in addition to the protection of the performance bond against contractor default and the protection of the payment bond against the contractor's failure to pay for labor and materials furnished.

5 Where and how do contractors and subcontractors obtain bonds?

When a contractor is ready to position his/her business to obtain surety credit, the first thing the contractor does is contact a professional surety bond producer and start developing that relationship.

Surety bond producers are business professionals who specialize in providing surety bonds for contractors, subcontractors, material suppliers, and other construction project participants. They are knowledgeable about the surety and construction markets and focus their activities on the surety market and on positioning construction firms to qualify for surety credit. They provide invaluable business advice and expertise to assist a contractor in securing surety credit.

They obtain from the contractor extensive information and documentation needed to evaluate a request to bond a contract. The information and documentation, which the bond producer will forward to a surety company for the prequalification process, is likely to include, among other things, the following:

- ✔ Contractor's questionnaire, covering detailed personal and company information
- ✔ Past 3 fiscal year-end financial statements
- ✔ Current interim financial statement and aged receivables and payables report
- ✔ Copies of bank loan agreements, including lines of credit
- ✔ Current personal financial statements on closely held company owners
- ✔ Current work-in-progress report
- ✔ Resumés of owners/key employees
- ✔ Letters of recommendation
- ✔ Evidence of current insurance coverages
- ✔ Copies of contracts the contractor is interested in bonding

A surety company evaluating the issuance of bonds for a contractor reviews and analyzes this information in a thorough and ongoing process called prequalification. Bond producers nurture an ongoing relationship between the contractor and the surety company. They develop and maintain a relationship of trust, commitment, respect, and teamwork. This relationship continues throughout the period that the contractor maintains surety credit, as each bond issued is separately underwritten.

Surety bonding is an intricate process, and each surety company has its own underwriting standards and practices. Business philosophies, market niche, and underwriting practices vary from company to company. The bond producer understands these differences and can match the needs of a contractor with a surety company that is best suited to service those needs.

In short, the bond producer works to position the contractor to qualify for surety credit and plays "matchmaker" between the contractor and the surety company. This typically becomes a long-term relationship of trust, often lasting decades, wherein the bond producer becomes a valued business advisor to the contractor.

6 What is a bid bond and what is its purpose?

A bid bond provides financial protection to the obligee (who can be the owner when the general contractor provides the bond, or the general contractor when the subcontractor provides the bond) if a bidder is awarded a contract but fails to sign the contract or provide the required performance and payment bonds. The bid bond also helps to screen out unqualified bidders, as a surety will not issue a bid bond on behalf of a contractor that it believes cannot fulfill the contract obligations of a construction contract. Prequalification means that the surety has investigated the contractor and determined that the contractor has the ability to carry out the work under the construction contract. A bid bond does not guarantee any portion of the construction.

The surety's specific obligation under the bid bond is set forth in the bond itself. In almost all instances the surety is obligated to pay the owner the cost of having to repeat the bidding process if the awarded bidder is unable or unwilling to perform. The surety's liability is generally limited to the face amount, or penal sum, of the bond, which is typically in the range of 5 to 20 percent of the contract bid price. Sometimes, however, owners require a forfeiture bid bond, which requires the surety to pay the owner the entire penal sum of the bond. Sureties are generally reticent to issue forfeiture bid bonds because the amount of the forfeiture doesn't necessarily relate to and is often much more than the actual damages incurred by the owner.

7 What is a performance bond and what is its purpose?

A performance bond provides an obligee with a written guarantee that, in the event of a contractor's default, the surety will complete the contractual obligations, make funds available to finish the work, or reimburse the bond obligee for the damages arising out of the contractor's default. Practically speaking, this means that, if the contractor is properly default terminated, the project will proceed to completion through one of the surety's options. Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.

If the bonded contractor fails to perform its work in accordance with the plans and specifications, the owner, having performed its contractual obligations, has a right to obtain completion of the contract from the surety. The amount 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 any statutory provisions that require bonds on public works projects, dictates the rights and obligations of the surety and the obligee.

Architects cannot make claims under performance bonds.

8 What is a payment bond and what is its purpose?

A payment bond ensures that certain claimants—typically, subcontractors and suppliers—will be paid for labor and materials incorporated into a construction project, if the bonded principal fails to pay them and can protect the owner from liens on its property. The language of the bond itself and/or any applicable statutes govern whether a party has a right to make a bond claim. A subcontractor or supplier that has a right to make a claim against a payment bond is referred to as a "claimant." Who a proper claimant is under a payment bond is typically restricted or limited by the language in the applicable statute, the contract, or the bond. Most payment bonds require a claimant that does not have a contract with the principal to give the principal or surety, or both, written notice of its claim within a specific period of time after furnishing the labor or materials for which the claim is made.

While architects cannot make claims under performance bonds, architects providing services can be proper claimants under certain payment bonds, depending on the specific language of the bond and any applicable statutes. This is, however, a minority approach; and typically architects have no payment bond rights.

Because claimants cannot place mechanics' liens against public property, the payment bond is likely the only protection claimants working on publicly funded projects have if the contractor does not pay for goods and services provided. While a payment bond does not directly benefit an owner, it provides indirect benefits by ensuring that unpaid downstream laborers and suppliers are unlikely to stop work during a project or, on private projects, file a lien, encumbering title to the project.

9 What is a warranty bond and what is its purpose?

A warranty bond, sometimes 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. While a performance bond protects the owner's project during the construction and usually one year after substantial completion, a warranty bond protects the project for a specified period of time after the project is complete and after the warranty period specified in the performance bond has run, typically one year.

Warranty bonds are typically used when an owner wants

coverage for a warranty period beyond one year, often one or two years. A warranty period can be extended for an annual fee, but sureties are reluctant to provide warranty protection for more than two years after project completion. If the contractor is unable to resolve the warranty issue or is not in business during the specific warranty period, the warranty bond provides the owner with a remedy.

Sometimes owners will require long-term warranties, such as five or more years. A long-term warranty period imposed on a contractor presents considerable problems for a surety. Sureties are usually comfortable with warranty obligations of two years. Durations longer than two years increase substantially the uncertainty regarding underwriting projections about the contractor's future viability. Long-term warranty obligations also reduce competition from the standpoint of eliminating from the bidder/proposer pool all but the largest contractors, since only large contractors can shoulder the higher risks inherent in such contracts. This has the effect of reducing the bidder pool, which, in turn, translates into higher prices paid for the project by the owner. A long-term warranty requirement precludes many highly qualified bidders, lowering bid and price competition.

10 Are bonds required on public projects or private projects, or both?

Contract surety bonds are required in most instances by the federal government, state governments, and local governments; and private owners and general contractors often require surety bonds, recognizing their importance in project risk management.

Under the federal Miller Act and certain regulations, any federal construction contract valued at $150,000 or more requires a performance bond and a payment bond. To be eligible to write surety bonds on federal construction contracts, a corporate surety must be certified by the U.S. Treasury Department, which conducts a financial review of the surety and sets a single bond size limit for the surety. A listing of certified surety companies approved to provide bonds on federal contracts, known as Department Circular 570 (or the T-List), is updated once a year and is posted by the Department of Treasury, Bureau of the Fiscal Service, Surety Bond Section at **www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm**.

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. Many 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 construction projects for the same reasons the government does. In the same manner, as a risk management tool, prime contractors will often elect to require that their subcontractors obtain performance and payment bonds. Sometimes construction lenders require bonds on projects as a condition for providing financing.

11 Who are individual sureties and what do I need to know about them?

In the United States, almost all surety bonds are written by insurance companies regularly engaged in the business of acting as a surety. Surety companies typically are authorized and qualified to do business by the state insurance commissioner where they are domiciled and in the jurisdiction where the bond is issued. The state departments of insurance regulate surety companies, which must meet minimum capital requirements, file periodic financial reports in those jurisdictions where they are authorized to do business, and are subject to market conduct investigations, among other regulatory requirements and actions.

While most surety bonds are written by insurance companies, almost all state insurance laws allow natural persons, not just companies, who wish to act as a surety on bid, performance, and payment bonds to obtain a certificate of authority from the state insurance department. Without such certificate, sureties engage in unauthorized insurance activity.

The history of individual surety abuse is replete with case law of unauthorized individual surety deceptions, to the detriment of contractors, subcontractors, suppliers, and public and private owners. As noted in a report issued in 2013 by Maryland's Department of Insurance, *Final Report on the Analysis of the Practices of Corporate Sureties and Individual Sureties in Maryland*, individual sureties have engaged in misleading conduct, creating the illusion of a corporate form, misleading the public into believing that the same safeguards in place for corporate sureties exist for individual sureties.

The federal government does accept bonds from individual sureties—if they adhere to specific regulations governing their assets. Nonetheless, unlike the evaluation of corporate sureties by the Treasury Department, there is no central entity to evaluate individual sureties or their bonds; and, therefore, redress against such individuals is very limited.

12 What are the advantages to the owner and contractor in contract bonds v. bank letters of credit?

Project owners sometimes consider requiring bank letters of credit (LOCs) in lieu of bonds to provide financial protection in the event of contractor default. Owners should be aware of the important distinctions between surety bonds and LOCs. A bank LOC is a cash guarantee to the owner, who can call on the LOC on demand. The LOC is converted to a payment to the owner. While performance and payment bonds protect the owner from non-performance and protect certain subcontractors and suppliers from nonpayment should the contractor default, the performance of the contractor has no bearing on the bank's obligation to pay on the LOC.

Contract surety bonds and LOCs both provide financial protection to the owner; but bonds are superior to LOCs in their effect on borrowing capacity, duration, coverage, cost, contractor qualification, and claims. Bonds do not diminish the contractor's borrowing capacity; bank LOCs do diminish a contractor's line of credit or collateral, which could adversely affect the contractor's cash flow.

Surety bonds remain in place for the duration of the contract, plus a warranty period, subject to the terms and conditions of the bond, the contract documents, and governing statutes. LOCs are usually date-specific, often for one year. They may contain "evergreen" clauses for automatic renewal, with associated fees; otherwise, they may expire.

Under the American Institute of Architects bond forms, a performance bond is 100% of the contract amount for project completion; a payment bond is 100% of the contract amount to protect certain subcontractors and material suppliers. An LOC can be obtained for a percentage of the contract amount, but 5%-10% of the contract amount is typical, which amount may not address the scale of the loss. An LOC provides no protection that subcontractors and suppliers will be paid in the event of contractor default. Accordingly, they may file liens on private projects.

The cost for both the performance and payment bonds is generally 0.5%-3% of the contract price and is included in the contractor's bid price. The cost of an LOC is generally 1%-2% annually of the LOC amount.

A surety company analyzes a contractor's operations, financial resources, experience, organization, workload, management, and profitability to determine that the contractor is capable of performing the contract, in order to avoid default. A banker examines the quality and liquidity of the contractor's collateral in the event there is a demand on the LOC. Other than determining if the contractor can reimburse the bank if demand is made on the LOC, there is no further

prequalification performed by the banker regarding the contractor's specific abilities or its abilities to perform the contract.

If the owner declares a contractor in default and the surety, after its independent investigation, determines that the contractor defaulted, the surety will select a completion option for performance and pay the rightful claims of subcontractors and suppliers, up to the penal sum of the 100% performance and payment bonds. With LOCs, the bank will pay an LOC on demand if made prior to the expiration date; but the owner must administer completion of the contract and determine the validity of claims and the amounts of payment to the subcontractors and suppliers.

13 What are the advantages to the owner in using bonds rather than subcontractor default insurance?

Subcontractor default insurance (SDI) is a two-party, catastrophic insurance policy that provides general contractors with insurance coverage for direct and indirect costs of trade contractor default. Some general contractors, generally those with subcontract volume exceeding $50 million, that are eligible for SDI coverage see it as an alternative to the purchase of subcontract bonds. Unlike subcontract bonds, SDI is traditional insurance that presumes some level of losses; and general contractors that purchase SDI must bear a significant level of self-insurance for such risks through high deductibles and co-payments. Little or no losses in the SDI program might translate into higher margins for the insured general contractor. It is critical to understand, however, that SDI, as a product, is very different from surety bonds and is never a replacement for statutory federal, state, or local bond requirements.

SDI can put a much bigger burden on the prime contractor than subcontractor bonds. With subcontract bonds,

Key Aspects of Subcontract Bonds and Subcontractor Default Insurance (See Q&A No. 13)

ISSUE	PERFORMANCE AND PAYMENT BONDS	SUBCONTRACTOR DEFAULT INSURANCE
Prequalification Process	Conducted by the surety, a knowledgeable third party (extensive and ongoing)	Conducted by the general contractor, not a third party
Structure	3-party agreement (general contractor, subcontractor, and surety)	2-party agreement (general contractor and insurer)
Regulation	Sureties are regulated by state insurance departments	Surplus lines basis and regular insurance market
Risk	Complete risk transfer from general contractor to surety, with first-dollar coverage of 100% performance bond and 100% payment bond	General contractor retains a portion of risk through high deductibles and co-payments
Payment Protection for Subcontractors and Suppliers	100% payment bond, with first-dollar payment benefit for subcontractors and suppliers	No payment benefit for subcontractors and suppliers
Subcontractor Default Management	If subcontractor defaults, surety completes, arranges for, or pays for subcontract completion up to bond amount	General contractor must manage subcontractor default, including completion of subcontractor's work
Payment of Losses	Surety pays losses after independent investigation	General contractor must first pay losses and then submit documentation to recover from the insurer
Legal Precedents	Extensive history of case law/legal precedents	Little or no case law/legal precedents
Confidentiality of Subcontractor Information	Subcontractor has confidential and on-going relationship with surety	Subcontractors are uncomfortable providing sensitive financial data to the general contractor (who might be their competitor bidding on the next project)
Premium	Cost calculated based on contract amount, depending on size and type of project	Cost is calculated on general contractor's program costs and the deductibles and co-payments selected
Cancellation	The bonds cannot be cancelled	SDI can be cancelled by the insurer
Indemnity	Subcontractor is incented to perform by its indemnification obligation to the surety	SDI provides no such incentive other than for the subcontractor not to be sued by the insurer

the surety performs the prequalification of potential subcontractors; in the event of default, provides complete risk transfer from the general contractor to the surety, with first-dollar coverage; manages the subcontractor default; and provides payment protection for lower-tier subcontractors and suppliers. With SDI, the general contractor performs the prequalification of the potential subcontractors; in the event of default, retains a portion of the risk through high deductibles and co-payments; manages the subcontractor default, including completion of the subcontractor's work; and there is no payment protection for lower-tier subcontractors and suppliers.

Accordingly, significant losses can jeopardize the operations of the insured general contractor, which will bear the expenses of the deductibles and co-payments and the burden of administering claims. The benefits of SDI flow only to insured general contractors, while the benefits of subcontract bonds flow not only to general contractors but also to subcontractors and suppliers and, indirectly, to owners.

The following chart is a broad overview of the features and purposes of subcontract bonds and SDI, with key aspects of each:

14 What is the cost of the bonds?

The cost of a bond is based on rates filed by insurance companies with the state insurance department and is based on the contract amount, not the bond amount. The cost of a bond can vary, from less than 0.5% to as much as 3% of the contract price. For a small and emerging contractor with minimal experience, a contractor can expect to pay 2-3% of the contract price. There are adjustments to the bond cost based on the final contract price. If the price increases, there's an increase in premium; and if the price decreases, the cost is reduced as well.

15 When are bond premiums typically paid?

Bonds must be paid when they are executed. Bonds are non-cancelable.

16 How extensive is the surety's prequalification process?

Contractor prequalification, as performed by surety underwriters, involves a thorough and continuing process of reviewing and evaluating balance sheets, work-in-progress schedules, and financial statements. Surety underwriters will also evaluate factors such as the risk under the specific contract for which the contractor seeks a bond, the contractor's entire work portfolio, past performance, experience, operational efficiency, managerial skills, business plan, and reputation for integrity.

Obtaining bonds is more like obtaining bank credit than purchasing insurance. Different sureties will stress varying factors during the underwriting process, but almost all will consider the following factors:

- ✔ Character/integrity
- ✔ Financial capacity
- ✔ Net worth
- ✔ Cash flow
- ✔ Assets
- ✔ Credit score
- ✔ Work in progress
- ✔ Work history, including expertise and experience
- ✔ Banking relationship
- ✔ Nature of project to be bonded

Surety underwriting is an ongoing evaluation process, which includes the principal's entire work program, both bonded and unbonded work.

17 What is a general indemnity agreement?

A general indemnity agreement, or GIA, is a contract between a surety company and a contractor. The GIA is a powerful legal document that obligates the contractor and other indemnitors to protect the surety company from any loss or expense that the surety has as a result of having issued bonds on behalf of the bond principal. In this manner, the contractor and other indemnitors have "skin in the game" for each contract, as the contractor's GIA incents the contractor from walking away from a bonded contract. Under a GIA, if the contractor fails to fulfill its bonded obligation under a contract and the surety suffers any loss, the indemnitors are legally bound to indemnify, or pay back, the surety for its losses.

A fundamental concept of suretyship is that the surety will not sustain a loss. The surety expects to be indemnified (that is, paid back) and reimbursed for any payments or losses by the principal and indemnitors under the indemnity agreement. Therefore, the GIA is needed before the surety issues any bonds on behalf of the principal. The GIA will apply to all bonds issued by the surety for the principal.

Because courts will routinely enforce the terms and conditions of GIAs, the GIA is an extremely powerful document that encourages contractors to honor and to fulfill their bonded obligations.

18 What determines a contractor's bonding capacity?

Contractor bonding capacity is a term used in the industry that refers to the maximum value of bonds a contractor is approved for by a particular surety. Owners should be interested in a contractor's bonding capacity because it reflects the surety's evaluation of the strength of the construction firm—in terms of quality of the organization and team, quality of financial ratios and metrics, and past performance, among other factors.

There is the single limit, which is the maximum value of a single bond for any project, and there is the aggregate limit (or bond line), which is the maximum total amount or value of bonds a contractor can get. This amount is critical to a contractor's business because it specifies the biggest job that a contractor can bid on when surety bonds are required.

Bonding capacity, like bank credit, is dependent on strong financials and adequate liquidity for a contractor to undertake the backlog of construction projects. Contractors need to have sufficient cash flow in terms of cash and working capital to be able to upfront the costs for insurance, bonding, labor, materials, and overhead for 60 to 90 days until they receive the first payment certification from the owner. Multiple projects require organization, cash flow, and plenty of managerial experience.

Under similar circumstances, bonding capacity will always favor those contractors that have superb financial information, which can be provided to surety companies on a transparent and timely basis, showing organization, commitment, and security that problems arising during the normal and customary business environment will be identified and dealt with immediately. Other important factors include a successful track record for the same types of projects, experienced personnel and subcontractors, on-time accounts receivable collection (that is, no collection problems), and sufficient bank lines of credit to assist in case of a temporary situation where the contractor may not collect certifications on time.

Although bonding is as much an art as a science, the better organized a contractor is in terms of project construction and administration matters, the higher the chances are that bonding capacity will match or exceed the contractor's expectations.

19 Why are sureties uncomfortable with long-term warranties? Do extended warranties cost extra or affect the availability of bonds?

Yes, extended warranties do cost extra; and, yes, they do affect the availability of bonds. A lengthy warranty period, such as one of 5 or more years, imposed on a contractor or subcontractor poses considerable problems from a surety underwriting perspective. Sureties are usually comfortable in covering a warranty obligation of up to two years. "Certainty" is a word that sureties like. Durations longer than two or three years increase substantially the uncertainty regarding underwriting projections about the contractor's future viability. In other words, sureties cannot gauge the soundness and financial wherewithal of a particular construction company for periods extending too far into the future.

Long-term warranty obligations also reduce competition from the standpoint of eliminating from the bidder/proposer pool all but the largest contractors, since only large contractors can shoulder the higher risks inherent in such contracts. This has the effect of reducing the bidder pool, which, in turn, can translate into higher prices paid for the project by the owner. Such longer warranty requirements effectively preclude many highly qualified contractors, significantly lowering bid and price competition on such projects.

Construction projects typically involve a number of different warranties, both of workmanship and of items incorporated into the work, such as roofing systems and equipment.

Those warranties provided by a contractor, as opposed to pass-through warranties from the manufacturer to the owner, need to be of limited duration.

20 If the general (or prime) contractor requires its subcontractors to be bonded, is the owner protected, too?

When a general contractor requires bonds from its subcontractor, the subcontractor's performance bond provides protection to the general contractor for the subcontractor's failure to perform the bonded subcontract. The subcontract performance bond provides no direct protection to the owner; however, the owner indirectly benefits by having the general contractor address its downstream risks through subcontract bonds. Subcontract bonds do not address the performance risks of the general contractor to the owner; only the general contractor's performance bond addresses that risk. Without a performance bond from the general contractor, the owner has no direct protection if the general contractor defaults under the prime contract.

21 What is a dual obligee bond?

A dual obligee bond, sometimes called a co-obligee bond, names an additional obligee to the bond. An additional obligee might be named in the bond itself or will be added in a dual obligee rider, to extend a surety's obligation under the bond to that interested third party. The additional obligee is usually a construction lender, although other entities having some interest in the completion of the project, such as title insurers, can also be dual obligees.

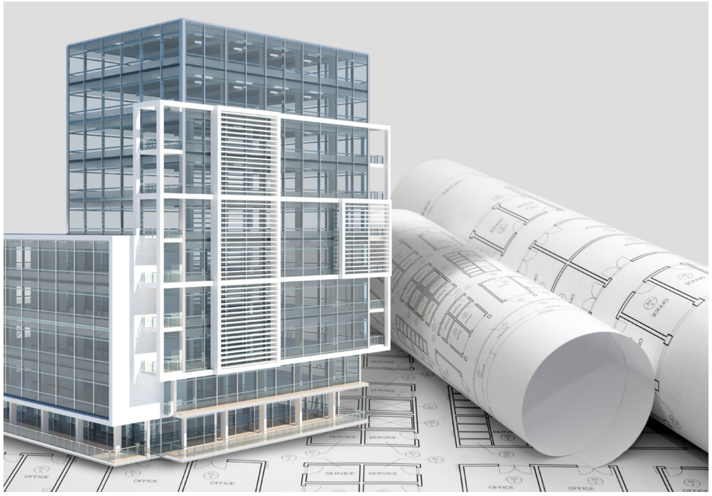
The addition of a dual obligee on a bond should not change the extent of the surety's liability under the bond, if the bond contains a "savings clause." An example of a savings clause in a dual obligee rider is the following:

> The Surety shall not be liable under the Bond to the Primary Obligee, the Additional Obligee, or any of them, unless the Primary Obligee, the Additional Obligee, or any of them, shall make payments to the Principal (or in the case the Surety arranges for completion of the Contract, to the Surety) strictly in accordance with the terms of said Contract as to payments and shall perform all other obligations to be performed under said Contract at the time and in the manner therein set forth.

The purpose of the savings clause is to place both the primary obligee and the additional obligee in the same position and subject both to the same defenses. A savings clause will relieve a surety from liability under the bond, to either and both of the obligees, if either of the obligees fails to make payments strictly in accordance with the terms of the bonded contract or fails to perform all other obligations under the bonded contract.

22 What are the obligations, if any, for an owner to provide copies of payment bonds to potential claimants?

Private owners generally are not required to provide copies of payment bonds to potential claimants, although some standardized contract agreements include the right of subcontractors to request copies. Most public owners, however, have obligations to provide such bonds upon request. The Federal Acquisition Regulations (FAR) provide



authority for subcontractors and suppliers and prospective subcontractors and suppliers on federal projects to request and obtain copies of payment bonds from the contracting officer. FAR 28.106.6(d) provides as follows:

> Upon the written or oral request of a subcontractor/supplier, or prospective subcontractor /supplier, under a contract with respect to which a payment bond has been furnished pursuant to the [Miller Act], the contracting officer shall promptly provide to the requester, either orally or in writing, as appropriate, any of the following:
>
> (1) Name and address of the surety or sureties on the payment bond.
>
> (2) Penal amount of the payment bond.
>
> (3) Copy of the payment bond. The contracting officer may impose reasonable fees to cover the cost of copying and providing a copy of the payment bond.

23 Is it important for an owner to communicate early with the surety in addressing potential performance defaults?

Yes. A surety's ability to favorably impact a default is directly related to the owner's keeping the surety informed of potential problems on the project. An owner's early communication with the surety vastly improves the surety claims process. Many contractors and subcontractors, however, are excellent problem solvers; so overzealous notification of potential problems can lead to complications.

Some performance bonds require a meeting among the obligee, principal, and surety prior to any declaration of default. Even if the bond does not require it, such a meeting is almost always useful. If there are such serious problems on the job that the obligee is considering a termination for default, the surety wants to know about it. Surety claims professionals are experienced in dealing with troubled projects, often leading to avoidance of a default termination.

The surety has the ability to advance funds to finance contract completion by the principal. The surety in this circumstance has an interest is making sure that contract funds are used on the bonded project.

24 Can sureties help avoid performance defaults?

Yes. There are hundreds/thousands of situations where sureties have mitigated performance problems. And that is why it is critically important that an owner communicate early with the surety about any potential performance problems of its bonded principal. If the surety is unaware of problems, it cannot begin to address them.

A surety that is made aware of problems by its bonded principal, claimants, or the owner, or all three, is potentially in a good positon to help mitigate issues before the owner takes drastic measures. To that end, sureties have the ability to offer their principals assistance; accounting and technical assistance are typical examples. One unseen benefit is where a surety takes control of contract funds and provides additional capital to a struggling contractor to avoid a default. This may happen without the obligee knowing that a problem exists and happens more often than many obligees realize.

25 What happens in a performance default situation?

A performance bond provides assurance that an obligee will be protected if the principal fails to perform a bonded contract. It is a "safety net." If the contractor materially breaches the contract and the owner declares the contractor in default, the surety has an obligation to the owner, under the performance bond, to honor the obligation. The surety has both a right and a duty to promptly conduct an independent investigation of the owner's allegation that the contractor is in default under the contract and the contractor's position that it is not in default.

The process of making a bond claim is governed by the entire body of construction law and precedents associated with the construction industry. The surety must respond to an owner upon notice of default without jeopardizing the rights and defenses of the contractor as it conducts its investigation. A surety is obligated to respond to a claim after investigating the facts associated with the alleged default of the contractor.

26 Why is a formal termination needed before a surety will assume the responsibility for performance of a contract?

Two contractors cannot perform the same work for an owner and a surety at the same time. Although sureties will insist that they cannot assume responsibility for performance unless the contractor is terminated by the owner, that does not mean they cannot and should not investigate the problems and consider alternatives to improve performance prior to termination.

If the obligee decides to terminate the bonded contract, the surety and the obligee generally have a number of options. Some bond forms describe the options, and some forms are silent. Whether or not the bond sets forth the options, it always makes sense to explore all possible options for the resolution of disputes and the completion of bonded work.

27 Why does the surety have different options in the event of a default?

If, after it has conducted its independent investigation, the surety decides to perform, it may have a variety of performance options that it must evaluate. Each has its advantages and disadvantages. It is not in the obligee's best interests to restrict the surety's options. The obligee that insists that the default be remedied in only one way may miss opportunities for saving time, money, and frustration.

28 What are typical options available to the surety to remedy a performance default?

Tender Option
The surety and the obligee can agree on a replacement contractor to complete the bonded work. This is referred to as the surety's "tender option," because the surety "tenders" a new contractor to the obligee. If the replacement contractor's price exceeds the balance remaining in the bonded contract, the surety will fund the excess either by paying the replacement contractor as the work proceeds or by paying the obligee the amount of the overrun in return for a release. Typically, the obligee and the surety will insist that the replacement contractor provide new bonds from its own surety to guarantee its performance of the completion work.

Takeover Option
Another option is for the surety to assume or "take over" responsibility for completing the remaining work. The surety would then hire construction professionals to manage and perform the completion.

If the takeover option is used, the surety and the obligee often will enter into a "Takeover Agreement" setting forth their respective rights and obligations in connection with completion of the work.

Allow Obligee to Complete
Another option is for the surety to elect not to be involved in the completion work. In this scenario, the surety remains exposed to the owner for the costs to complete in excess of the remaining contract balance up to the penal sum of the bond.

Because this option leaves the surety with little or no control over the manner in which the work will be completed, it is not one often exercised. The most common situation in which the surety elects this option is if the job is close to completion and the obligee's plan for finishing the work is reasonable.

Denial of Claim
If the surety, after its independent investigation, concludes that it has no liability under its bond, the surety will generally deny the claim.

Other Options
Other options might include up-front cash settlements, continued performance by the original contractor, and various combinations of all the possible options.

29 How does an owner know if a bond is valid and has been authorized by the surety?

There are, unfortunately, unscrupulous persons and entities in the marketplace that prey on owners, contractors, and subcontractors by issuing fraudulent surety bonds. Therefore, it is critical that an owner confirm that the surety is authorized in the jurisdiction of the project and that the bond has been issued by that surety. This task can be performed by undertaking the two-step process set forth below:

1. Check the authority of the surety to issue the surety bond:
   - Contact the state insurance department to determine if the surety is admitted in the jurisdiction of the project. Generally, sureties must have a certificate of authority from the insurance commissioner in each state in which they conduct business. The National Association of Insurance Commissioners provides a map with links to all state insurance departments, at **www/naic.org/state web map.htm**. Some states list admitted sureties on the insurance department website, but a quick call to the department will ensure the most current and complete information.

- Consult the U.S. Department of the Treasury Listing of Approved Sureties, Department Circular 570. To provide surety bonds on federal construction projects, a corporate surety must possess a certificate of authority from the U.S. Treasury Department. A listing of certified surety companies approved to provide bonds on federal contracts, known as Circular 570 (or the T-List), is posted by the Financial Management Service, Surety Bond Branch of the Department of Treasury, at **www.fms.treas.gov/c570/index.html**.

2. Verify that the surety actually authorized the issuance of the surety bond:

   - Contact the surety directly to receive verification that the surety bond has been duly authorized. All sureties listed in Circular 570 identify a specific contact phone number. In addition, the Surety & Fidelity Association of America administers a program in which surety companies voluntarily agree to receive inquiries for the purpose of verifying the authenticity of surety bonds, in the SFAA Bond Obligee Guide, at **www.surety.org/?page+VerifyYourBond**.

Nothing should replace an owner's exercise of due diligence regarding the authenticity of surety bonds. The internet is replete with stories of owners, contractors, and subcontractors that have been subject to fraudulent bonds.

30 What are bondability letters?

Bondability letters, also called "good guy letters" or "sunshine letters," do nothing more than evidence that a contractor has a surety company relationship. Owners or general contractors that require bondability letters from sureties for their general contractors or subcontractors, respectively, do so with the intent to have evidence of prequalification. A bondability letter, however, does not provide any kind of prequalification for a particular project or make any promise that the contractor would be able to get a bond for a particular job. It is purposefully vague and written at the 50,000-foot level to give a high overview of the contractor's bondability.

If an owner wants to know if a general contractor (or if a general contractor wants to know if a subcontractor) is qualified to perform specific work, the owner should require a bid bond so that the contractor would be properly prequalified by the surety for a specific contract.

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