



Contract Surety Bonds

Protecting Your Investment



How do you evaluate and manage risk on your construction projects? How do you ensure that your projects are completed

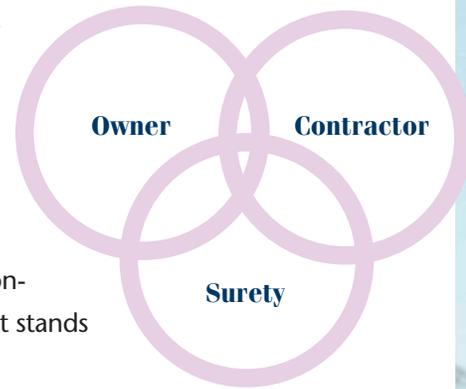
on time, on budget, and to contract specifications? How do you ensure that contractors and subcontractors successfully meet their obligations?

One way is with bid, performance, and payment bonds. Specifying surety bonds ensures capable and qualified contractors and subcontractors and protects you from financial loss in the event of contractor failure.

How Do Surety Bonds Work?

With a surety bond, the surety company and its financial resources stand behind the contractor, which enables the contractor to enter into a contract. You receive a bond from a financially responsible surety company licensed to transact surety. Surety bonds provide protection by screening out unqualified contractors. Before contractors can obtain a surety bond, they undergo a rigorous prequalification process, called underwriting, to determine whether they are capable of performing a given contract. When a surety underwrites performance and payment bonds, it stands behind the contractor's promise to:

- perform the work according to the contract's terms and conditions, and
- pay certain subcontractors, laborers, and material suppliers.



SURETY BONDING IS A THREE-PARTY RELATIONSHIP AMONG THE OWNER, CONTRACTOR, AND SURETY.

Types and Benefits of Contract Surety Bonds

Bid Bond	Assures that the bid has been submitted in good faith, the contractor intends to enter into the contract at the price bid, and the contractor will provide the required performance and payment bonds.
Performance Bond	Protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
Payment Bond	Assures that certain subcontractors, laborers, and material suppliers will be paid in the event of contractor default, and prevents subcontractors from filing mechanics' liens on the project.

Prequalification

The fundamental concept of contract surety is that contractor default is preventable. Surety companies spend a great deal of time and expense in the underwriting process to qualify a contractor before issuing a surety bond. This effort keeps contractor defaults to a minimum.

Since surety companies back their promises with their own assets, they conduct a careful, professional, and rigorous prequalification review of the contractor. Because surety companies and bond producers have been evaluating contractor and subcontractor performance for more than a century, they possess the expertise, experience, and objectivity to effectively prequalify the contractor and assure project completion. The surety bond premium is a fee for this expertise and financial backing.

Because a contractor's bonding capacity affects his or her ability to acquire work, the contractor provides more comprehensive information to the surety than to the owner. The surety company and producer have access to detailed financial information; ongoing analysis of the contractor's strengths and weaknesses; and information on past, current, and future work.

The surety bond underwriter has the formidable task of assessing the strength of a construction firm based on a prediction of profits on uncompleted jobs and the analysis of the contractor's cost systems, billing patterns, timeliness of completion, and likelihood of profitability.

Surety professionals make informed decisions to prequalify the contractor. Their unique relationship with a contractor allows them to evaluate each element and determine whether the

What Surety Professionals Analyze

Financial Strength

- Annual & interim financial statements
- Investment strategies
- Cost control mechanisms
- Work in progress (bonded & non-bonded)
- Cash flow
- Net worth
- Working capital
- Bank & other credit relationships

Ability to Perform

- Prior experience on similar projects
- Equipment
- Personnel
- Past, current, and future workload (bonded & non-bonded)
- Continuity plan
- Organization
- Management plan

Reputation With

- Project Owners
- Subcontractors
- Suppliers
- Lenders

contractor can complete the job. It is more economical to have a surety professional perform the prequalification than for an owner to maintain a staff or hire a consultant for this purpose.

Subcontractors

Subcontractors have a significant impact on the profitability of your projects. Two significant risk factors are their ability to fulfill their contractual obligations and their right to file mechanics' liens. Performance and payment bonds offer substantial protections from both.

Subcontractors who are unable to perform can bring your 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. The general contractor is responsible for its subcontractors. However, when the general contractor requires key subcontractors to obtain performance bonds, you are assured of qualified subcontractors on your project.

Subcontractors deserve the protection of a payment bond. No matter how qualified the subcontractors are, if the general contractor fails to pay them you run a significant risk of project delays and mechanics' liens. However, when you specify a payment bond, certain subcontractors, laborers, and suppliers are assured payment in the event of contractor default. The surety company investigates claims made on the payment

bond and pays subcontractors directly when the contractor is found in default of the payment bond. A claim of non-payment may even occur after the project is complete or nearly complete, even if the owner has already paid the contractor for the work. Keeping key subcontractors on the job can help keep a project moving toward timely completion.

Cost

The cost of a performance bond is a one-time premium, which typically ranges from 0.5–2% 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 contractor generally includes the bond premium amount in the bid.

Contract Amount	Bond Premium
\$100,000	\$1,200–\$2,500
\$1 Million	\$7,700 –\$13,500
\$10 Million	\$56,950–\$81,000
\$50 Million	\$206,475–\$341,000

Rates may vary depending on the size and type of the project and the contractor's bonding capacity. These rates are approximate and are intended to provide examples of the range of rates an owner might expect.



ALTHOUGH THE CONTRACTOR LAID THE FIRST STONE FOR THE COLLEGE'S FIRST BUILDING IN 1892, IT WAS NO GUARANTEE OF A LIEN-FREE PROJECT TODAY.

A Contractor's History Is No Guarantee

When Northland College in Ashland, Wisconsin decided to build the \$12 million Larson-Juhl Center for Science and the Environment, the Board of Trustees didn't require performance or payment bonds.

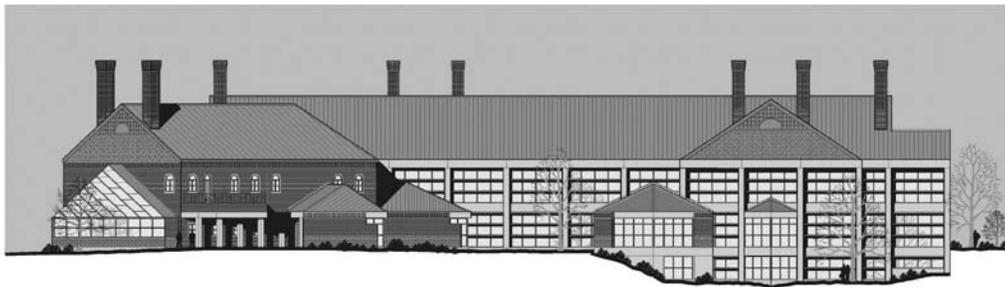
According to Harold Vanselow, Vice President of Finance and Administration, the college's Board of Trustees chose the construction company "because of its history with the college. It had been in business for more than 100 years and the owner's great-grandfather laid the first stone for the first building of the college when it was built in 1892." A former owner of the construction company was at one time a trustee

himself, and the company had successfully performed other projects for the college. By all accounts, it appeared the college made an informed decision on choosing a contractor.

Vanselow stated that, "The project continued on schedule and on budget, and the college made all payments to the general contractor in full, and on time." It came as quite a surprise when, after the project was nearly complete, seven subcontractors filed liens totaling nearly \$900,000 because the contractor hadn't paid them.

Because the Board of Trustees was so eager to develop a great science facility, it did not recognize the value of a bond. The Board believed the \$70,000–\$100,000 bond premium could be better used on equipment and supplies for the new building. Now the college must find a way to settle \$900,000 in liens on the completed project.

Realistically, a contractor with a 100-year history of work on college projects who has successfully completed similar projects for similar contract amounts, and who had a good reputation with the owner doesn't sound like much of a gamble. But the risk in construction often lies in the uncontrollable, unpredictable, and unknown.



SOUTH ELEVATION
SCALE: 1/8" = 1'-0"



**NORTHLAND
COLLEGE'S
PLANS FOR
THE LARSON-
JUHL CENTER
FOR SCIENCE
AND THE
ENVIRONMENT**

According to one of the subcontractors on the job, the company was having financial difficulties because of some problem jobs a few years earlier. Surety professionals make informed decisions when prequalifying a contractor for a bond. They look at the financial strength of the contractor, the management structure and ability, the volume and makeup of other work the contractor is performing, as well as the character and reputation of the contractor. Any one of these elements can cause a contractor to fail. This unique relationship with a contractor allows the surety underwriter to evaluate each element and guarantee that the contractor can complete the job for the owner.

Reputation alone does not complete contracts and a solid contractor can become an insolvent contractor very rapidly if one or more of the elements changes. The small fee for prequalification and the surety's financial guarantee of the project are very valuable products to an owner. The relationship that an owner has with a contractor is arm's length while a surety's relationship is a day-to-day partner. A surety has much greater insight as to a contractor's abilities to perform than an owner.

Specifying a Bond

To require a bond on a project, simply state the requirement in the contract specifications. It is the contractor's responsibility to contact a surety bond producer and obtain the necessary bonds. The surety bond producer, also called an agent or broker, guides the contractor through the prequalification process and helps him or her develop a business relationship with a surety company.



When the contractor submits a bond, read the bond form carefully and understand its provisions. Make certain all data is entered correctly and that it is signed and dated. Bond form language is important in determining the surety company's responsibilities and liabilities. The bond form should:

- Stipulate the parties to the bond;
- Indicate the surety company's maximum financial obligation—known as the "penal amount" of the bond;
- State the surety company's obligations under the bond;
- Include the construction contract and specifications by reference;
- Provide a brief description of the project; and
- Give the location of the project.

Learn More

For information on standard bond forms, go to www.sio.org/faq.html.

It Pays to Know the Surety Company

Before you accept a bond, it is important to verify that it is from a reputable surety company. Contact your state Insurance Department or visit its Web site to confirm that a surety company is licensed to do business in your state. As with any product, know what you are purchasing and take a few minutes to know with whom you are dealing.

The Southgate Recreation and Park District in Sacramento, CA learned this lesson the hard way. A developer donated 146 acres to the park district adjacent to 1,100 acres he intended to subdivide. The stipulation was that the park district would build a golf course within four years or the land would revert to the developer. It sounded like a good deal for everyone—the park district would receive valuable land, the public would have a golf course, and the developer would receive a tax break and increase his property's value.

A feasibility study estimated golf course construction at \$3.9 million. The low bid was \$3 million and the next lowest bid was \$4 million. With such a huge gap, the park district should have questioned whether the low bidder submitted a responsible bid. However, lured by savings of \$1 million, the park district awarded the contract to the lowest bidder. When the second-lowest bidder notified the owner that the contractor's surety company was questionable, the park district did nothing.

Soon after the project began, the contractor experienced financial problems. He was spread too thin on other projects, was unable to pay subcontractors and suppliers, and soon filed bankruptcy, leaving the owner with an unfinished project and \$500,000 in subcontractors' claims. The park district soon learned that the surety company was just a shell and the bonds were "illegal and unenforceable." Had the park district heeded the warning signs and checked with the state Department of Insurance, it would have learned that the surety company was neither licensed nor approved to do business in the state.

It is unlikely that a responsible, licensed surety company would have bonded the original contractor. Said a California Department of Insurance spokesman, "If there was more due diligence on the front end, this type of thing could be avoided." While the case is still in litigation, that "free" land and \$1 million bid spread may end up costing the park district several million dollars.

Learn More

For information on researching a surety company, see SIO's brochure, *Surety Companies: What They Are and How to Find Out About Them* at www.sio.org/html/suretiesare.html. To access a state insurance department Web site, go to www.naic.org/state_web_map.htm.

Contractor Failure— Prevention and Response

Surety underwriters and surety bond producers are a valuable resource to contractors, using their experience and knowledge to help contractors avoid extreme risks and overcome challenges. Most major surety companies have construction attorneys, accountants, and engi-

neers to help viable contractors through temporary problems. The surety company can proactively respond in many different ways, and not just when a contractor defaults on a project.

The surety underwriter is trained to make impartial judgments about whether a contractor can perform the contract, and does not expect a loss. However, losses do occur. Contractors may default if there are drastic financial changes in the economy, unforeseen changes in job site conditions, or death or illness of a key employee. Usually, it takes a combination of events to force a contractor into default. When that happens, the professional expertise of the surety company and surety bond producer is there. With the

Why Contractors Fail

Accounting and Management Issues

- Inadequate financial, accounting, and project management systems
- Change in ownership and/or personnel
- Change in scope of business
- Rapid over-expansion (volume and/or territory)

Labor and Material Issues

- Subcontractor failure
- Non-bonded subcontractors/
selective bonding of
subcontractors
- Labor and/or material shortages
- Cost escalations

Work Environment Issues

- Onerous contract terms and conditions
- Unexpected economic downturn
- Inclement weather

surety company's technical knowledge, practical experience, and resources and the cooperation of the contractor and owner, losses can be minimized and the job completed to the satisfaction of all parties.

A minimal number of defaults signifies that surety companies have been successful in screening out unqualified contractors from the bidding process. If inadequately financed or incompetent contractors are allowed to bid, particularly in the lowest bidder award system, the number and cost of defaults will increase.

The surety is paid for prequalifying the contractor and assuring that the contractor will perform. One of the most difficult variables to account for in the prequalification process is the interdependent nature of construction. The difficulties listed above may occur on other projects being performed by the contractor, which ultimately affects all projects on which the contractor is working (including yours!). These setbacks may occur with a subcontractor or supplier and eventually cause problems on your project. This is why it is important not only to have the prequalification process conducted by the surety, but also to have its financial backing in the event default occurs.

Default is an unfortunate, and sometimes unavoidable, circumstance. To reduce the likelihood of contractor default:

- 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.
- Notify the surety company of changes in the contract.

Learn More

For information on warning signs and events that lead to contractor failure, see SIO's brochure, *Why Do Contractors Fail?* www.sio.org/html/whyfail.html.



**United States Department of Commerce
National Oceanic and Atmospheric Administration**

It is with great pleasure that I convey to you the sincere appreciation of the National Oceanic and Atmospheric Administration (NOAA) for the involvement and assistance in a recent default action against...Construction Company. At the time of the action, [the contractor] had completed about eight percent of the NOAA's Marine Environmental Health Research laboratory located in Charleston, South Carolina...

When it became clear at the end of July that [the contractor] was experiencing performance problems, [we] issued a Cure Notice and concurrently made informal inquiry to your bond claims [department]. Your company was already aware of the financial difficulties that [the contractor] was experiencing and provided assurance that our concerns for priority consideration and minimal transition time to a replacement contractor was also your goal.

We normally refrain from contacting the surety until our default termination is executed and our claim is filed. In this case, anticipating the need to secure a successor contractor, we made initial contact with your bond claim office on July 23. Between then and August 20, an incredible amount of work was accomplished. [Surety company personnel] intervened to retain the original subcontractors and suppliers even though they had not been paid by [the contractor]. This, in itself, was no small feat. In addition, your staff expended a substantial effort in identifying, interviewing, and evaluating potential replacement contractors.

On August 20, following the due process of a show cause notice we issued the formal termination for default and concurrently made formal claim to you under the bond. On August 24, [surety company personnel], along with the proposed replacement contractor, met with us and legal counsel in Kansas City and developed an innovative tri-party takeover and tender and substitution agreement which was signed by all parties on August 26. A key component of the agreement was that [the contractor] would be on site that afternoon with work commencing the next day. As it turned out, that next day's work entailed securing construction materials on the site in anticipation of Hurricane Dennis.

The preceding is but a summary of a remarkable partnership that was formed. The key to this remarkable accomplishment was the involvement of your two "can do" employees. They are professional and competent in the performance of their duties and earned the respect of all parties to this project. We thank you.

Claims

The surety company has legal obligations to you and the contractor. It first must investigate a claim before taking action in order to protect the contractor's legal recourse in the event of improper declaration of default. On the other hand, the surety must keep in mind its obligations to you. To expedite the claims process, define default in the contract and communicate with the contractor and the surety company. Once notified of a default, the surety company independently investigates notices of disputes or claims and provides you with its assessment. Since this investigation must be impartial and responsible in order to meet state standards as well as their own company service requirements, claims investigations are thorough and can be time-consuming.

When the surety finds the contractor to be in default, it is obligated to respond to you and perform in accordance with the terms of the contract—subject to the limitations and understandings contained in the performance bond. In addition to this obligation, the surety may exercise its option to proceed in discharging its bond liability, if any, without risking a claim by the contractor for interference with the contract.

There are things you can do to manage the process:

- Verify 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 you recognize problems occurring on the project;
- 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;

If the surety company's investigation finds that the contractor has defaulted on the project under the performance bond, the surety company, in most cases, may:

- Re-bid the job for completion;
- Arrange for a replacement contractor chosen by the surety company;
- Retain the original contractor and provide trained personnel and/or financial assistance; or
- Reimburse the owner (pay 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.

Owner provides status reports to the surety company, with early notification of any problems

Owner files formal declaration of default or termination

Surety company acknowledges claim

Surety company conducts investigation

Surety company determines and fulfills obligations, if any

Learn More

For information on the claims process, see SIO's brochure, *A Construction Project Owner's Guide to Surety Bond Claims* at www.sio.org/html/claims.html. Claims case studies are available in *Surety Bonds at Work*, at www.sio.org/html/sbw.html.

Conclusion

After analyzing the risks involved with a particular project, consider how surety bonds protect against those risks. When a reputable surety company bonds a contractor, you, your banker, and investors are protected because:

- The contractor has undergone a rigorous prequalification process and is judged capable of fulfilling the obligations of the contract;
- Contractors are more likely to complete bonded projects than non-bonded projects since the surety company may require personal or corporate indemnity from the contractor;
- Subcontractors have no need to file mechanics' liens on the project when a payment bond is in place;
- Surety companies may prevent default by offering technical, financial, or management assistance to a contractor; and
- The surety company fulfills the contract in the event of contractor default.

Any contractor—whether in business for one year or 100, large or small, experienced or novice—can experience serious problems. Through the years surety bonds have held fast as a comprehensive and reliable instrument for minimizing the risks in construction.



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The Surety Information Office (SIO) is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles, and answer questions on contract surety bonds. SIO is supported by The Surety Association of America (SAA) and the National Association of Surety Bond Producers (NASBP). All materials may be accessed at www.sio.org.



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The Surety Association of America (SAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship. Member companies collectively write the majority of surety and fidelity bonds in the United States. SAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SAA represents its member companies in matters of common interest before various federal, state, and local government agencies.



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The National Association of Surety Bond Producers (NASBP) is the international organization of professional surety bond producers and brokers. NASBP represents more than 5,000 personnel who specialize in surety bonding; provide performance and payment bonds for the construction industry; and issue other types of surety bonds, such as license and permit bonds, for guaranteeing performance. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.