



Managing Project Risks Through Surety Bonds

An Overview of the Importance of Surety Bonds For Architects and Their Owner Clients

The owner's selection of a designer is a major factor in a construction project's success, and there is often close interaction between the owner and the designer from initial schematic design through project completion. 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. Such advice from a trusted architect includes helping the owner select various risk management protocols to help ensure the successful completion of the project. Surety bonds are a major risk management tool for project owners, but in the design community generally, surety bonds are an underappreciated and often misunderstood tool for transferring risk and enhancing the potential for successful construction projects.

The goal of this summary article and the more detailed linked articles on surety bonds and the bonding process is to provide architects with a better understanding of the essential role that surety bonds play in the construction risk management process. First, when a surety issues bonds on behalf of a contractor, that surety is providing assurance to the bond obligee that the contractor is capable of meeting its obligations under the bonded contract. Second, the 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 to the project. 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.



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. The two main benefits of 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.

Surety bonds that are written for construction projects are called contract surety bonds. There are four types of

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contract surety bonds, each of which transfers risk from the owner (or laborers and suppliers) to the surety: bid bond, performance bond, payment bond, and warranty bond. A bid bond provides the owner a means to recover the cost of having to repeat the bidding process or the difference between the lowest and second lowest bid when the bidder is awarded a contract but fails to sign the contract or provide the required performance and payment bonds. A performance bond provides the owner a written guarantee that, in the event of a 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. A payment bond ensures that certain subcontractors and suppliers will be paid for labor and materials furnished for use in the performance of the bonded contract. A warranty bond guarantees the owner that any workmanship and material defects found in the original construction will be repaired during the warranty period.

Pursuant to the federal Miller Act, performance and payment bonds are required on any federal construction contract valued at \$150,000 or more. Each state has a "Little Miller Act," similar to the federal Miller Act, which requires bonds for state contracts over a certain threshold amount. In the private sector, there is no mandate for the use of bonds for construction contracts; however, many private owners, understanding the risk management value of surety bonds, require them on their projects.

When a contractor is ready to position his/her business to obtain surety credit, the first thing the contractor does is contact a surety bond producer and start developing that relationship. The producer helps position the contractor to qualify for surety credit, obtains from the contractor information and documentation needed by the surety company to evaluate a request for bonding, and finds the proper surety market for each contractor, nurturing a successful relationship between the contractor and the surety company that issues bonds on behalf of the contractor.



Sureties are insurance companies or divisions of insurance companies that issue the vast majority of bonds in the United States. Surety companies determine whether a contractor is bondable through an underwriting process--called prequalification--that evaluates whether the contractor has the capacity, capital, and character to undertake the work under the contract.

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. The surety, once it has prequalified the contractor, issues bonds on behalf of that contractor. These bonds function to transfer risk from the owner to the surety.

An architect that understands the benefits of bonding projects will be better prepared to advise owners that bonds can help ensure successful projects, the ultimate goal of every design professional. Architects should not be the ultimate advisor to owners concerning surety bonds, but they should encourage the owner to consider their use on a project and to seek the advice of a knowledgeable construction/surety attorney.

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. For more information and to Be Guaranteed to Succeed, visit www.nasbp.org/guaranteed.

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