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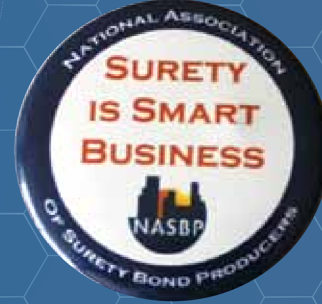

The TOP 10 THINGS Public Owners Should Know About Surety Bonds

SURETY BONDS ON a public construction project offer an owner the best possible fiscal and risk management tool: (1) thorough prequalification of the contractor and assurance that the bonded contractor is qualified to perform the contracted obligation; (2) a guarantee that the contract will be completed if the contractor defaults on its performance obligation; and (3) payment of certain laborers and suppliers if the contractor fails to pay for work performed or materials supplied. Surety bonds on public works projects protect the public treasury from the potentially devastating expense of contractor failure by transferring the burden of construction risk from the public owner to the surety company.

1 Surety bonds. A surety bond is a three-party contract, by which one party (a surety company) guarantees the performance of another party (the principal, who is a contractor) to a third party (the obligee, or the public owner). Surety bonds used in construction are called contract surety bonds.

2 Types of contract surety bonds. There are three main types of contract bonds that sureties provide. A **bid bond** helps to screen out unqualified bidders and provides the owner a means to recover the cost of having to repeat the bidding process if the awarded bidder is unable or unwilling to enter into the contract and supply the required performance and payment bonds. A **performance bond** provides an owner with a guarantee that, in the event of a contractor's default, the surety will meet its obligations under the bond to fulfill the construction contract. A **payment bond** assures that certain subcontractors and material suppliers will be paid, if the contractor fails in its payment obligations.

3 Licensed surety companies. Most surety bonds are written by divisions of insurance companies, which are licensed and regulated by state insurance departments. Unlike traditional two-party insurance policies, surety bonds are three-party agreements, in which the surety does not expect a loss. Through the surety's rigorous prequalification process, the surety expects the bonded contractor to perform its contractual obligations, significantly reducing the likelihood of default. Based on that expectation, the surety issues the performance and payment bonds guaranteeing those obligations. This is an enormous benefit to public owners, which are charged with guarding the public treasury.

4 Miller Act bond requirements. For nearly 80 years, the federal government has required contractors on federal public works projects to obtain surety bonds to guarantee performance of the contract and the payment of certain subcontractors and suppliers. Under the Miller Act, a contractor on federal construction contracts exceeding $150,000 must obtain both a performance bond and a payment bond. The corporate surety company issuing such bonds must be listed as a qualified surety on the Treasury List. All states, and many local jurisdictions, have similar legislation, called Little Miller Acts, which require surety bonds for public construction contracts over certain threshold amounts. Although statutory bond requirements vary, contract bonds typically are written so they provide 200 percent coverage for the original contract amount. The performance bond and the payment bond are each written for the full, original contract amount, ensuring thorough protection of the public.

5 **Surety bond premiums.** Surety bond premiums vary among sureties, depending on the size, type, and duration of the contract and the specific contractor. When bonds are required, it is the contractor's responsibility to obtain them; and the contractor includes the bond premium amount in the bid.

6 **Surety's prequalification of contractors.** The surety company's rigorous prequalification of the contractor is a critical attribute of surety bonds that protects the public owner and its treasury. One of the most valuable attributes of surety bonds is the experience, expertise, and objectivity of the surety company prequalifying the contractor. Contractors often develop long-term relationships with their sureties, who review not just a snapshot of the contractor but the contractor's entire work program and future plans. During the prequalification process, a surety will satisfy itself that the contractor seeking bonds has the following: experience concerning the contract requirements; financial ability to support its entire work program (not just the specific bonded project); ability to meet current and future obligations; good references and reputation; good credit history and financial statements; equipment required by the work or ability to obtain it; and an established bank relationship and lines of credit.

7 **Contractor's indemnity obligation to the surety.** Public owners frequently do not understand that, if a surety company determines it will extend surety credit to a contractor, the surety will typically require its principal (both in a personal and a corporate capacity), the individuals who control the company and their spouses, and often affiliated companies to execute a general agreement of indemnity (GIA). Among other things, the GIA obligates the named indemnitors to protect the surety from any loss or expense the surety sustains as a result of having issued bonds on behalf of the contractor. This indemnity obligation is a substantial incentive for the contractor to perform the contract properly because, if it fails to fulfill its bonded obligation and the surety suffers any loss, the indemnitors are legally bound to indemnify the surety for its losses. The surety's indemnity requirement ensures that the contractor has "skin in the game" and will be more likely to complete the bonded contract.

MOST SURETY BONDS ARE WRITTEN BY DIVISIONS OF INSURANCE COMPANIES, WHICH ARE LICENSED AND REGULATED BY STATE INSURANCE DEPARTMENTS.

8 **Silent services of the surety.** A seldom discussed, but important, benefit of surety bonds to public owners is the various kinds of assistance that a surety company offers to its bonded principal to avoid a contract default. Such services might include technical, management, and financial assistance to contractors. For instance, sometimes, and often unbeknownst to the public owner, a surety company will advance funds to a contractor that has a temporary financial shortfall so that the contractor can pay its subcontractors and suppliers and continue work under the contract.

9 **Bond claims process.** Contractor default is sometimes an unavoidable, and unfortunate, circumstance. Sometimes even best-in-class contractors fail, such as during an economic downturn. If a contractor defaults, the owner must declare the contractor in default. Then the surety will conduct an independent investigation before settling any claims. If the owner's default is proper, the surety's options are set forth in the performance bond and may include rebidding the contract for completion, using a replacement contractor, providing financial and/or technical assistance to the existing contractor, or paying the penal sum of the bond. The surety also will investigate and settle valid claims on the payment bond.

10 **No adequate substitutes.** Public owners should be aware that various alternatives to contract surety bonds surface periodically in the marketplace. These alternatives are touted generally as being less expensive than surety bonds. Besides the fact that these alternatives do not comply with bonding statutes, use of them would be penny-wise and pound-foolish. These so-called substitutes lack the transparency of surety bonds. The premium for surety bonds is transparent and all-inclusive; that is not often the case with alternatives, which do not provide the same services or the same benefits and often include hidden fees. Those entities offering such products lack the combined long experience and deep expertise of surety companies in prequalifying contractors, maintaining long-term relationships with contractors, providing assistance to contractors, completing a contract, and investigating and administering payment bond claims. As recognized by the extensive legislative mandates, surety bonds are **THE** comprehensive and reliable tools for minimizing risks to public owners in construction.