

\$13.8 billion from 1995 to 2014 due to contractor default, according to The Surety & Fidelity Association of America in Washington, DC. In 2014, the surety industry paid more than \$84 million in losses on private construction and has paid more than \$2 billion since 1995.

**9** When bonds are specified in the contract documents, it is the contractor's responsibility to obtain them. The contractor generally includes the bond premium amount in the bid, and the premium generally is payable upon execution of the bond. If the contract amount changes, the premium will be adjusted for the change in contract price. Contract surety bonds are a wise investment – providing qualified contractors and protecting public owners, private owners, and prime contractors from the potentially devastating expense of contractor and subcontractor default.

**10** After analyzing the risks involved with a construction project, consider how surety bonds protect against those risks. Owners, lenders, taxpayers, contractors, and subcontractors 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 because the surety company likely requires personal or corporate indemnity from the contractor;
- Subcontractors have no need to file mechanics' liens on private projects when a payment bond is in place;
- Bonding capacity can help a contractor or subcontractor grow by increasing project opportunities and providing the benefits of assistance and advice of the surety bond producer and underwriter;
- 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.

### **Surety Information Office (SIO)**

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The Surety Information Office (SIO), formed in 1993, disseminates information about the benefits of contract and other forms of surety bonding in private and public construction. SIO, a virtual office, is supported by the National Association of Surety Bond Producers (NASBP), www.nasbp.org, and The Surety & Fidelity Association of America (SFAA), www.surety.org. For information on the benefits of surety bonds in construction and in other contexts, contact the Surety Information Office at sio@sio.org.

### **National Association of Surety Bond Producers (NASBP)**

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The National Association of Surety Bond Producers (NASBP), founded in 1942, is the association of and resource for surety bond producers and allied professionals. NASBP producers specialize in providing surety bonds for construction contracts and other purposes to companies and individuals needing the assurance offered by surety bonds. NASBP producers engage in contract and commercial surety production throughout the U.S., Puerto Rico, Guam, and a number of countries. They have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.

### **The Surety & Fidelity Association of America (SFAA)**

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The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA 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. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

# 10 Things You Should Know



## About Surety Bonding



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**M**aking the right choice to mitigate and manage risk on construction projects and selecting the most fiscally responsible option to ensure timely project completion are imperative to a successful project—and a sound business.



Gambling on a contractor or subcontractor whose level of commitment is uncertain or who could become bankrupt halfway through the job can be an economically devastating decision. Surety bonds offer the optimal solution: providing financial security and construction assurance by assuring project owners that contractors are capable, in the surety's opinion, of performing a construction contract and paying specified subcontractors, laborers, and material suppliers.

**1** A surety bond is a three-party agreement where the surety company assures the obligee (owner) that the principal (contractor) will perform a contract. Surety bonds used in construction are called contract surety bonds.

**2** There are three primary types of contract surety bonds. The bid bond assures that the bid has been submitted in good faith and that the contractor intends to enter the contract at the price bid and provide the required performance and payment bonds. The performance bond protects the owner from financial

loss in the event that the contractor fails to perform the contract in accordance with its terms and conditions. The payment bond assures that the contractor will pay certain workers, subcontractors, and materials suppliers.

**3** Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and insurance policies are risk transfer mechanisms regulated by state insurance departments. Of 1,424,124 contractors in business in 2007 only 969,937 were still in business in 2009 – a 31.9% failure rate. Although surety rates are actuarially based and take into consideration the potential for loss, they also act as a fee for the surety's extensive underwriting and prequalification service.

**4** In 1894 Congress passed the Heard Act to protect federal projects from contractor default. The Heard Act was supplanted by the Miller Act in 1935, the current version of which requires performance and payment bonds for construction contracts in excess of \$100,000 (and by regulation \$150,000) and payment protection for contracts between \$30,000 and \$100,000. A corporate surety company issuing these bonds must be listed as a certified surety on the U.S. Department of Treasury List, Circular 570. Also, almost all 50 states, the District of Columbia, Puerto Rico, and most local jurisdictions have enacted similar legislation requiring surety bonds on public works. These generally are referred to as "Little Miller Acts." Owners of private construction also manage risk by requiring surety bonds.

**5** Construction is a risky business. Surety bonds offer assurance that the contractor is capable of completing the contract on time, within budget, and according to specifications. Specifying bonds not only reduces the likelihood of default, but with a surety bond, the owner has the peace of mind that a sound risk transfer mechanism is in place. The burden of construction risk is shifted from the owner to the surety company.

**6** Surety bond premiums vary from one surety to another, but can range from 0.5% to 3% (closer to 3% if the Small Business Administration's Surety Bond Guarantee is used) of the contract price and vary

depending on the size, type, and duration of the project and the contractor. Typically, there is no charge for a bid bond if performance and payment bonds are required on the project. In many cases, the cost of a payment bond and a 12-month maintenance bond is included with the purchase of a performance bond.

**7** The surety company's rigorous prequalification of the contractor protects the project owner and offers assurance to the lender, architect, and everyone else involved with the project that the contractor is able to translate the project's plans into a finished project. Surety companies and surety bond producers have been evaluating contractor and subcontractor performance for more than a century. Their expertise, experience, and objectivity in prequalifying contractors is one of a bond's most valuable attributes. Before issuing a bond, the surety company must be fully satisfied that the contractor has, among other criteria:

- good references and reputation;
- the ability to meet current and future obligations;
- experience matching the contract requirements;
- the necessary equipment to do the work or the ability to obtain it;
- the financial strength to support the desired work program;
- an excellent credit history; and
- an established bank relationship and line of credit.

**8** Contractor default is an unfortunate, and sometimes unavoidable, circumstance. In the event of contractor failure, the owner must formally declare the contractor in default. The surety conducts an impartial investigation prior to settling any claim. This protects the contractor's legal recourse in the event that the owner improperly declares the contractor in default. When there is a proper default, the surety's options often are spelled out in the bond. These options may include the right to re-bid the job for completion, bring in a replacement contractor, provide financial and/or technical assistance to the existing contractor, or pay the penal sum of the bond. That owners have been shielded from risk is evidenced by the fact that surety companies have paid more than