

# SURETY BONDS

The construction industry is a very competitive marketplace. In seeking to maintain a steady flow of work, contractors will encounter certain projects that require them to provide surety bonds guaranteeing their performance of the contract.

Surety bonds are required of contractors on public projects let directly by federal, state or local government agencies. But those are not the only instances of surety bond requirement. Private owners may require bonds of their contractors; trade contractors are generally bonded individually to the public owner on projects employing a construction manager; and subcontractors may be required to 'bond back' to the general contractor on public or private projects.

There are four basic categories of contract surety bonds:

1. The bid bond provides financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the price bid and provide the required performance and payment bonds. A bid bond is executed either in a dollar amount or percentage (typically 5-20 percent of the bid price).
2. The performance bond protects the obligee from financial loss should the contractor fail to perform the contract in accordance with the terms and conditions of the contract documents.
3. The payment bond guarantees that the contractor will pay all subcontractors, labor and material bills. A performance and payment bond is rarely executed for less than 50%-and most frequently 100% -of the contract price.
4. The maintenance bond guarantees for a specified period of time after completion of construction work that the contractor/principal will maintain his or her work in accordance with the contract warranty provisions. (A one-year maintenance bond is built into the performance bond form.)

Although most surety companies are also large insurance companies, qualifying for bonds is more like obtaining bank credit than purchasing insurance. Like a bank, the surety company wants to know the contractor well before committing its assets in support of the construction operation.

Most contractors find it both necessary and worthwhile to spend time establishing their relationship with a surety company. Since the surety company is guaranteeing a contractor's performance, it needs to gather and carefully analyze information before agreeing to the requested work programs.

The surety underwriting process is focused on pre-qualifying the contractor. It takes some time to develop and present data, address questions the surety may have and verify credit and performance experience. Before issuing a bond, the surety must be satisfied that the contractor is of good character; has the experience that matches the requirements of the projects to be undertaken; and has, or can obtain, the equipment necessary to perform the work.

The bond company frequently looks to the principals of a contracting organization to stand behind their company, just as the bond will do. When the principals and their spouses "sign on the dotted line," they are putting all their assets at risk, in support of the construction operation they are undertaking. This confirms to the bond company that they aren't likely to turn their backs on the bond company should it

have to spend money to complete a project. The bond company may use personal net worth, or liquidity, to bolster the strength of a case. Rarely will it exhaust personal net worth when enforcing the indemnity in the event of claim. Furthermore, the contractor's home is generally exempt from seizure in claim reimbursement proceedings.

Contract surety bond rates can vary in at least two ways. First, there are several different classes of bonds. For example, most building and sub-trade construction work is classified Class B. Most road paving work is classified Class A. The Class A rates are somewhat lower than Class B. Second most surety companies have a standard rate and a 'preferred' rate for both Class A and Class B bonds. Surety companies generally have a number of qualifying requirements for their preferred rate. Surety rates are set and approved by the state.

Financial strength and a good credit rating can have a positive impact on the final rate.

If you are in need of a surety bond, you should first contact your regular insurance agent. The insurance company or companies represented by your regular insurance agent may provide you with a surety bond. Preferably, you should try to work with an insurance agent trained in the selling of surety bonds. If your regular insurance agent does not handle surety bonds, he or she should be able to provide you with one or more references

SCORE worked closely with Willis Corroon in preparing this handout. This handout is based on information provided by Willis Corroon printed material and discussions with their management.