The contractor has undergone a rigorous bonding process, and special trade contractors operating in 2009, only 702,618 were still in business in 2011—a 21.72% failure rate. Despite the surety’s rigorous prequalification process and best judgment about the qualifications of the contractor, sometimes contractor default is unavoidable. However, when a contractor fails on a bonded project, it is the surety company that remedies the default—not the project owner and not at taxpayers’ expense.

In the unfortunate event that a bonded contractor does default, the surety has legal obligations to the project owner and the contractor. First, the owner must formally declare the contractor in default. Then the surety company conducts an impartial investigation before settling any claim. This protects the contractor’s ability to pursue legal recourse in the event that the owner improperly declares the contractor in default. When there is a proper default, the surety has legal obligations to the project owner and the contractor. First, the owner must formally declare the contractor in default. Then the surety company conducts an impartial investigation before settling any claim. This protects the contractor’s ability to pursue legal recourse in the event that the owner improperly declares the contractor in default. When there is a proper default, the surety has legal obligations to the project owner and the contractor.

Benefits of Bonds

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 since the surety company may require personal or corporate indemnity from the contractor;
- Subcontractors have no need to file mechanic’s liens on a private project when a payment bond is in place, and because mechanics’ liens cannot be placed against public property, the payment bond may be the only protection these claimants have if they are not paid for the goods and services they provide;
- Bonding capacity can increase a contractor’s or subcontractor’s project opportunities;
- The surety bond producer and underwriter may be able to offer 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.

Surety Information Office (SIO)

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The Surety Information Office (SIO), founded 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.

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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.
The Importance of Surety Bonds in Construction

Historical Perspective
Surety bonds have been a valuable tool for centuries. The first known record of contract suretyship was an etched clay tablet from the Mesopotamian region around 2750 BC. According to the contract, a farmer drafted into the service of the king was unable to tend his fields. The farmer contracted with another farmer to tend them under the condition they split the proceeds equally. A local merchant served as the surety and guaranteed the second farmer’s compliance. Suretyship was addressed in the first known written legal code, the Code of Hammurabi, around 1792-1750 BC. A Babylonian contract of financial guarantee from 670 BC is the oldest surviving written surety contract. The Roman Empire developed laws of surety around 150 AD that exist in the principles of suretyship today.

While suretyship has a long history, it wasn’t until the 19th century that corporate surety bonds were used. Recognizing the need to protect taxpayers from contractor failure, Congress passed the Heard Act in 1894, which required surety bonds on all federally funded projects. The Miller Act of 1935 required surety bonds on all federal public works. It requires performance bonds for public work contracts in excess of $100,000 and payment bonds for public works projects, the use of surety bonds on privately owned construction projects is at the owner’s discretion. Alternative forms of financial security, such as letters of credit and self-insurance, do not provide the 100% performance protection and 100% payment protection of surety bonds. Prequalification of the Contractor
Sureties are able to accept the risk of contractor failure based on the results of a thorough, rigorous, and professional process in which sureties prequalify the contractor. This prequalification process is an in-depth look at the contractor’s business operations. 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;
- The experience matching the contractor project profile;
- The necessary equipment to do the work or the ability to obtain it;
- The financial strength to support the desire work program;
- An excellent credit history; and
- An established bank relationship and line of credit.

The surety company must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly, and performs obligations in a timely manner. Surety bonds have played an important role in the construction industry’s success, allowing the industry to sustain its position as one of the largest contributors to the nation’s economic stability and growth.

Contractor Failure
Construction is a risk-filled enterprise, and even capable and well-established contractors can ultimately fail. According to BizMiner, of the 897,602 general contractors and operative builders, heavy construction companies operate on a different business model. Subcontractors may also be required to obtain surety bonds to help the primary contractor manage risk, particularly when the subcontractor is a significant part of the job or a specialized contractor that is difficult to replace. Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms. Subcontractors may also be required to obtain surety bonds from their prime contractor. When a contractor fails, it is difficult to replace. Surety companies operate on a different business model. Surety is designed to prevent loss. The surety company must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly, and performs obligations in a timely manner. Surety bonds have played an important role in the construction industry’s success, allowing the industry to sustain its position as one of the largest contributors to the nation’s economic stability and growth.

Risky Business
How one evaluates and manages risk on construction projects and makes financially responsible decisions to ensure timely project completion is key to success. To gamble on a contractor whose level of commitment or qualification is uncertain or who could become bankrupt halfway through the job can be a costly decision. How can a public agency using the low bid system in awarding public works contracts be sure the lowest bidder is dependable? How can private sector construction project owners manage the risk of contractor failure? Surety bonds provide financial security and construction assurance by requiring project owners that contractors will perform the work and pay specified subcontractors, laborers, and material suppliers. A surety bond is a risk transfer mechanism where the surety company assures the project owner that the contractor will perform in accordance with the contract documents.

Types of Bonds
There are three basic types of contract surety bonds:

- The bid bond assures that the bid has been submitted in good faith and that the contractor will enter into the contract at the price and provide the required performance and payment bonds.
- The performance bond protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- The payment bond assures that the contractor will pay specified subcontractors, laborers, and material suppliers on the project.

Financial Security & Construction Assurance
Although surety bonds are mandated by law on public works projects, the use of surety bonds on privately owned construction projects is at the owner’s discretion. Alternative forms of financial security, such as letters of credit and self-insurance, do not provide the 100% performance protection and 100% payment protection of surety bonds nor do they assure a competent contractor. With surety bonds, the risks of project completion are shifted from the owner to the surety company. For that reason, many private owners require surety bonds from their contractors to protect their company and shareholders from the enormous cost of contractor failure. To bond a project, the owner specifies the bonding requirements in the contract documents. Obtaining bonds and delivering them to the owner is the responsibility of the contractor, who will consult with a surety bond producer. Subcontractors may also be required to obtain surety bonds to help the prime contractor manage risk, particularly when the subcontractor is a significant part of the job or a specialized contractor that is difficult to replace. Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms. Subcontractors may also be required to obtain surety bonds from their prime contractor.