the same prequalification process as any other contractor. Other risk management tools for subcontractor default do not involve prequalification of the subcontractor.

With a surety bond, in the case of subcontractor default, the surety handles the business side of the default in conjunction with the general contractor. Alternate forms of risk management do not provide the owner or general contractor with a guarantee of contract completion as a surety bond does.

The Surety's Role in Contract Completion

When claims occur, the borrower's rights are protected, in turn protecting the lender. The surety provides assistance when necessary, which may include providing financial/technical assistance to the contractor, arranging for a completion contractor, paying subcontractors and suppliers to keep the job moving, and/or providing trained personnel to consult and solve problems on the job. By guaranteeing that the contract will be completed, contract surety bonds assure you, the construction lender, that your financial investment is protected.

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.

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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.

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Protect Your Construction Lending Capital with Surety Bonds

Affordable Protection

Protect Your Construction Lending Capital with Surety Bonds

Construction is a risky business, and the need to protect private owner investment capital remains. According to BizMiner, one in four contractors fails. For years, surety bonds have been mandated by law for federal public construction projects (exceeding $150,000) under the Miller Act of 1935. Many state and local governments also require surety bonds on their public construction projects with "Little Miller Acts." Surety bonds have been used voluntarily for many private projects as well. Moreover, an increasing number of construction financiers are now are recognizing the wisdom of requiring contract surety bonds to protect loans secured by private sector projects.

Basics of Contract Surety Bonds

Surety bonds, like traditional insurance, are provided by insurance companies and are licensed and regulated by state insurance departments. However, surety is a unique form of insurance in which the surety company's financial resources back the contractor's commitment to enter into a contract with an owner. In order to obtain a surety bond, the contractor must qualify by meeting the surety's comprehensive underwriting standards.

Bonds are a three-party agreement among the owner (obligee), the contractor (principal), and the surety company, and the surety company is obligated to both the obligee and the principal. There are three types of surety bonds:

- 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.
- The **performance bond** assures the owner that the contractor is capable and qualified to perform the contract and protects the owner from financial loss should the contractor fail to meet the terms and conditions of the contract. A qualified, bonded contractor is more likely to complete the project according to the contract provisions. Default is not in the best interest of the surety, contractor, or owner. When problems occur on a bonded project, however, the surety may offer assistance.
- The **payment bond**, sometimes called a labor and material bond, assures that the contractor will pay certain subcontractors, laborers, and material suppliers associated with the project.

Basically, surety bonds protect a project owner by guaranteeing the contractor's performance and payment for labor and materials. When a contractor provides a surety bond, you can be assured that it has met the surety company's rigorous prequalification standards. Indirectly, construction lenders also are assured that the project will proceed according to the terms of the contract. Thus, the parties are required to fulfill their financial and performance responsibilities—with protection from events that might inhibit project completion or cause financial loss.

How Sureties Prequalify Contractors

The fundamental concept of contract surety is that contractor default is preventable. Surety companies spend a great deal of time and expense in the underwriting process to qualify a contractor before issuing a surety bond. This effort keeps contractor defaults to a minimum. Because a contractor's bonding capacity affects its ability to acquire work, the contractor provides more comprehensive information to the surety than to the owner. The surety company and producer have access to detailed financial information, ongoing analysis of the contractor's strengths and weaknesses, and information on past, current, and future work.

This is an example of what the contractor may be asked to provide for prequalification:

- An organization chart of key employees and their responsibilities
- Detailed resumes of key employees
- A business plan outlining the type and size of work sought, prospects for such work, the geographic area in which the company operates, and growth and profit objectives
- Current work in progress as well as a history of the largest completed jobs, including names and addresses of the owners, contract price, dates completed, and gross profit earned
- A continuity or completion plan outlining how the business will continue to operate in the event of the owner's death or disablement (The surety may suggest that the plan include life insurance on key owners with the construction company named as beneficiary.)
- Evidence of a bank line of credit to augment working capital and to handle temporary cash flow deficits or strains. Sureties will look at the security for the credit and the extent to which bank loans are used and the amount and terms of their repayment.
- Sureties generally look for an unsecured line of credit or a line of credit obtained through the long-term financing of equipment or real estate.
- Letters of recommendation or references from subcontractors, owners, architects, and engineers on completed projects

Mitigating Subcontractor Default

Payment bonds on construction projects protect covered subcontractors and material suppliers, assuring them that they will be paid if the general contractor defaults. This encourages more subcontractors to be willing to work on the project and at a better price because of the reduced risk. Surety bonds also protect general contractors from subcontractor default. Bonded subcontractors go through