The Surety Safeguard

How Bonding Protects Taxpayer Dollars

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When a government entity awards a construction contract to a contractor, it knows that the contractor's surety bond company stands behind the contractor's promise to complete the job according to the owner's specifications and terms of the contract. A surety's prequalification of a contractor decreases the chance of contractor failure, but contractor failure sometimes is inevitable. When such failure occurs, taxpayers are protected against virtually all losses caused by contractor failure.

That's because surety bond companies provide the resources necessary to complete the contracts and pay certain bills for laborers, material suppliers, and subcontractors. Obtained by contractors from surety bond companies, surety bonds transfer the risk of contractor failure to the surety.

A Long History

The idea behind surety bonding is simple and direct. One person guarantees to another that a third person will perform.

This concept isn't new. In fact, the Bible refers to surety bonding in Proverbs 11:15: "He that is surety for a stranger shall smart for it, and he that hateth suretyship is sure." However, the ancients used individuals instead of surety bond companies, and these individuals often proved to be unreliable. The earliest recorded attempt to form a company to engage in the surety business was in 1720. And in 1865, the United States' first corporate surety bonding company, the Fidelity Insurance Company, was formed.

Concerns About Contractor Failure

In 1894, Congress passed The Heard Act in response to concerns about the large number of contractors working on public projects that became insolvent and in response to complaints from unpaid subcontractors. The Heard Act was supplanted by the Miller Act in 1935. Since then, the federal government has required that contractors obtain surety bonds for public works, and virtually all the states have followed with their own statutes, called "Little Miller Acts."

Today, surety bonds protect almost every public construction project across the country. Every year, billions of dollars in public works projects are under construction throughout the United States with surety bonds providing valuable protection against contractor failure.

Why Bonds?

Anyone familiar with the construction industry knows that several potential problems—some in the contractor's control and others not—can lead to default or bankruptcy if they are not addressed properly. An economic downturn, labor difficulties, material shortages, the death of a key employee, equipment problems, bad weather, even fraudulent activity, can bring a project to a standstill, often causing the contractor to default and bills to go unpaid.

Surety Speeds Rush Hour Traffic

An $18.4 million construction contract in Leon County, Florida, called for the widening of a major roadway from four lanes to eight at the most traveled intersection in the City of Tallahassee. The contract specified construction of a flyover bridge, access ramps, improvements to numerous feeder roads, and access points to dozens of businesses.

When the contractor faced financial difficulties, the surety company worked closely with the contractor to maintain normal financial and business operations. Not only did the project continue without interruption, but also it was completed ahead of schedule.

The surety's Large Loss Team, comprised of a claims representative, home office accountants, an engineer, and external consultants, analyzed the necessary information and developed a plan to complete the project.

The surety paid labor and material suppliers from a joint account into which all contract payments were deposited. The surety made frequent visits to the project and provided engineering expertise and retained a consulting firm familiar with contract surety default matters. The firm reviewed all project payments to subcontractors and suppliers and provided technical assistance on the day-to-day operations.

The County Board of Commissioners expressed its appreciation to the surety stating, "[The surety] has proven its resourcefulness and dedication to efficient and smooth-running operation," and completion was a result of the surety's "quest for excellence and proven service."

No construction project owner—public or private—can gamble that a contractor could go bankrupt halfway through the job. A state highway department, for example, not only wants to be sure that the contractor hired to build a new bridge will be technically competent and financially fit for this project, but also that the lowest bidder is competent to perform the work, dependable, and will not put taxpayers' dollars at risk.

Surety Bonds Protect Public Funds

This essential assurance to the public is provided by surety bonds. A surety bond is a risk transfer mechanism: the risk of contractor default is shifted from the project owner (the government or a private party) to the surety company. If contractor failure does occur, it is the surety company that remedies the default—not the government, not the taxpayer. When a contractor provides a surety bond, the public can be assured that the contractor has met the rigorous prequalification standards of an independent third party, the surety bond company.

A **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 **performance bond** protects taxpayers against financial loss should the contractor default or fail to complete the job according to the terms and conditions of the contract.

A **payment bond** guarantees that the contractor will pay certain laborers, material suppliers, and subcontractors associated with the project.

Bid, performance, and payment bonds are three types of contract surety bonds. Surety bond companies offer several other types of bonds, which are described briefly at the end this document.

It is important to note that bid, performance, and payment bonds are not intended to protect the contractors that post them. Instead, these bonds are intended to protect the owner of the construction project against contractor failure and to protect certain laborers, material suppliers, and subcontractors against nonpayment. Since mechanic's 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 to the project. Small and emerging contractors are most likely to participate on public projects as subcontractors, and this payment bond protection is critical to their financial stability and growth.

Surety Keeps Subs Paid and on the Job

A contractor was hired by a regional transit authority to build a commuter garage near a local train station. Originally, the garage was supposed to be completed within 14 months of the project start date. Over two years later, the garage still was not complete, and the contractor was having financial troubles. The transit authority terminated its contract with the builder.

Upon the default and termination of the contractor, the surety not only moved quickly to pay the subcontractors the amounts they still were due from the original contractor, but also re-engaged the subcontractors to complete their remaining work.

Protection through Prequalification

Surety underwriting focuses on prequalifying the contractor. This prequalification process is critically important. The surety bond company is committing its assets to guarantee a contractor's performance and payment of certain laborers, material suppliers, and subcontractors. That is why surety bond underwriters analyze applicants closely. They must be certain that only those who in their opinion can successfully complete a particular job receive a bond. To bond all contractors regardless of their abilities would make the prequalification process useless and would, in fact, increase contractor defaults.

Before issuing a bond, the surety underwriter must be satisfied that the contractor runs a well-managed profitable enterprise, keeps promises, deals fairly with others, and performs obligations in a timely manner. The surety underwriter also has to examine a contractor's history of paying laborers, material suppliers, and subcontractors. It is essential that the contractor has the experience that matches the requirements of a specific construction project; someone who has built only driveways likely would not qualify for bonds as the major contractor on a major highway project, for example.

In-depth Analysis of Contractor's Business Operations

How does the surety underwriter make judgments concerning the contractor's job experience, management characteristics, and financial health? He or she gathers and analyzes information from the contractor and various other sources. Some of the information a contractor provides the underwriter includes:

- an organizational chart showing key employees and their responsibilities and resumes;
- a business plan outlining growth and profit objectives, how jobs are obtained, job size and scope, bidding practices, and geographic areas in which work is performed;
- a list of completed projects over the past five years with size, completion date, and final gross profit;
- financial statements over the past three to five years, including accountant's opinion page, balance sheet, income statement, expense schedule, changes in financial status, and a schedule of contracts in progress;
- references from subcontractors and suppliers;
- letters of recommendation from owners, architects, and engineers;
- evidence of a line of credit at the bank and credit history; and
- a continuity plan.

After this information is analyzed, the surety bond company will make its decision. If the comprehensive prequalification process yields a positive conclusion, the surety underwriter then can consider each specific bond request by the contractor.

Working Together

Surety bonds are obtained through insurance agents and brokers, called producers. These producers guide their contractor clients through the prequalification process and

Surety Gives Green Light for Traffic Control System

A contract for the Virginia Department of Transportation (VDOT) called for the installation of a sophisticated traffic management system on a bridge. A subcontractor to the prime contractor was hired to design and install the system. Unfortunately, the system was seriously flawed and never performed to the specifications mandated by VDOT.

Since the traffic signaling system was a major component of the contract, claims were made against the prime contractor and the performance bond.

The surety supported the contractor in an exhaustive investigation of the problem. With support from the surety, the contractor attempted to rectify the technical problems, but despite its best efforts, was unable to provide a workable traffic system. The contractor could not afford the cost of remedial work or the cost of outright replacement. VDOT declared the contractor in default and called on the surety to correct the problems and complete the contract.

The surety promptly solicited proposals from other contractors with expertise in the very technical field of traffic management systems. Even the lowest responsive bid to replace the defective system with a workable one required hundreds of thousands of dollars in excess of the remaining contract balance. The surety honored its obligations and provided a check to VDOT for the excess completion costs and tendered an acceptable contractor that completed the contract to VDOT's satisfaction.

help them develop a business relationship with the surety bond company. Producers work closely to assist the contractor in preparing the necessary information and addressing any questions the surety bond company underwriter may have. The producer also may help the contractor seek out work in order to build a track record that will assist in obtaining surety bonds for larger, more sophisticated projects.

What is the cost of this protection? The price or premium for a bond normally ranges from 0.5%–3%[1] of the contract price and on large projects is often less than 1%. There generally is no charge for the payment bond when it is purchased in conjunction with the performance bond.

Rates are actuarially based and take into consideration the potential for loss. This fee covers the cost of the surety's in-depth prequalification process, varies from company to company, and also depends on the size and type of project and the contractor's bonding capacity. The contractor includes the premium in the bid, and the owner pays the bond premium.

[1]Bond premiums tend to approach 3% when the Small Business Administration Surety Bond Guarantee Program is used. Otherwise, the premiums generally fall in the 0.5-2% range.

It is clear that the in-depth process needed to prequalify a contractor isn't a simple matter of using standardized formulas, filling in the blanks, and then simply stamping "approved" or "rejected" on the contractor's bond application.

Surety Keeps Contractor from Financial Ruin

The contractor, a specialist in road work, was the low bidder on a job to build a roadway through an affluent residential neighborhood where the residents were not in favor of the roadway. The completion date left little time for problems.

The job had a large amount of material that had to be delivered on time and in specific sequence. The supplier was unable to meet these conditions, which put the job on a downward spiral. Disputes ensued with the supplier as the project owner demanded to know how the job would be kept on schedule.

As problems escalated, the surety became involved in an advisory capacity. During the next three months, the owner declared the contractor in default three times, each time changing its mind after meetings with the surety and keeping the contractor on the job. To compound the problem, a severe storm caused extensive damage to the work in progress. Tensions mounted and the owner wrote yet another letter of termination to the contractor.

Again the surety met with the contractor and owner and their attorneys. The owner agreed to retract the termination letter, and the contractor agreed to complete the contract. A week later, the contractor informed the surety that he did not have the resources to complete the job. Additional costs of errors in materials shipments and interference from the owner had driven costs much higher than he could absorb.

The surety began financing the costs of the work and hired another contractor and a consultant to assist the bonded contractor in finishing the work.

Thanks to the surety's establishment of a limited working line of credit for the contractor, the owner was satisfied with the completed project while the contractor survived the adverse financial situation.

The surety bonding process involves considerable time and effort by the contractor, the producer, and the surety bond company, which makes the final judgment based on the surety underwriter's analysis of the contractor's managerial and financial capabilities.

Keeping Politics Out

Few government agencies awarding public works contracts have the staff, expertise, and underwriting skills that professional surety bond companies have. Moreover, there are differences in opinion among surety bond companies, and the competitive surety marketplace permits the contractor to look elsewhere if declined by one surety bond company. Should a government entity perform the prequalification, the contractor would either pass or fail based on a set of fixed criteria, and if rejected, there would be no alternative market. What is most important is that the surety bond company is independent of the contract award system. In this way, the use of surety bonds keeps politics out of the contractor prequalification process.

Government Oversight

There are many surety bond companies that sell bonds in the United States. Some are insurance companies specializing primarily in writing surety bonds; others are large property/casualty insurance companies that have surety bond departments and provide other types of insurance coverage as well.

Project owners rely on surety bond protection in part because surety bond companies are regulated by state insurance departments. In general, surety bonds on state public works must be issued by a surety bond company licensed by the insurance department in that state. State insurance departments conduct periodic examinations of surety companies and enforce all insurance laws that pertain to surety bond companies.

In addition, the U.S. Treasury Department maintains a list of surety bond companies that it has qualified to write surety bonds required for federal construction projects. To be included on this list, a surety bond company must file financial and other information with the Treasury Department and pass the Department's financial analysis. Surety bond companies that do not meet these standards can be removed from the list. The Treasury List may be downloaded at **http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm**.

Availability of Surety Bonds

Surety bonds are available to contractors of all sizes. It is true that not every contractor has the credit history, experience, and financial capacity to obtain bonds or may not qualify for as much bonding as it might wish. Nevertheless, it is the intent of the surety bond industry to judge all applicants for bonding on their merit regardless of size.

In fact, a number of surety bond companies specialize in marketing bonds to small contractors. In addition, several major surety bond companies have initiated programs to bond more small contractors. Many surety bond companies have designed special strategies that encourage their producers and underwriters to seek small contractor business. Approximately 190,000 federal, state/municipal, and private contract bonds for less than $500,000 were written countrywide in 2013. Their total bond value was approximately $31 billion.[2]

[2]These figures take into account captured adjustment under $500,000 to what could be a large bond. *Source: The Surety & Fidelity Association of America.*

Many surety companies offer fast-track programs designed for small or emerging construction contractors that are just getting into public bidding and have smaller surety bond needs. The application process is simplified and requirements for obtaining a bond are less stringent through these programs.

Government also is playing a role in making surety bonds available. To maximize the opportunities for small contractors that want to take on bonded work, the federal government and some of the states have implemented special programs to enable surety bond companies to write bonds for small contractors that do not qualify for bonds under the companies' normal underwriting standards.

Surety's Interim Contractor Keeps Job Going Swimmingly

A contractor hired for plumbing work on the installation of a competitive-sized swimming pool and locker room facilities for a large Midwestern high school voluntarily defaulted in the early stages of the project. The contractor informed the surety late on a Friday afternoon of the default. The early plumbing work was crucial for the advanced stages of the project.

The surety hired an interim contractor who started on the job the following Monday morning while competitive bids were sought for the remaining unfinished work. In just more than four weeks, the surety's completion contractor was on the project. The project proceeded to completion within the contract time and with no additional cost to the owner.

Since the early 1970s, the Small Business Administration (SBA) has operated its Surety Bond Guarantee Program, which provides surety bond companies with partial repayment against loss stemming from bonds they would not normally provide. With the help of the SBA program, small contractors have performed more than $1 billion of contracts per year.

Helping Small Contractors through Educational Programs

To prepare small and emerging contractors for bonding or help them to increase their bonding capacity, several organizations—including SFAA and NASBP—offer educational opportunities. SFAA's Model Contractor Development Program (MCDP)® was developed to help small contractors understand the bonding process and provide them with support to improve their business operations. During the educational component of the MCDP®, participants learn how surety bonding relates to all aspects of their business operations and specific approaches and techniques that result in a successful bond application. The bond readiness component consists of one-on-one interactions with surety bond producers, underwriters, and other professionals who work with participants to help assemble the materials and information necessary for a complete bond application. They also address any omissions or deficiencies that might deter the successful underwriting of a bond.

The U.S. Department of Transportation's Bonding Education Program (BEP) is based on SFAA's MCDP®. Both programs are hands-on, multi-component programs designed to address what businesses need to do to become bond-ready, as well as one-on-one sessions with local surety bonding professionals to help in assembling the materials necessary for a complete bond application. The BEP is tailored to businesses competing for transportation-related contracts. SFAA has entered into several partnerships with state and local governmental jurisdictions, trade associations, and non-profit organizations around the country that utilize the MCDP® as a model in designing and implementing contractor development, bond education and bonding assistance programs in their locales.

A number of state departments and agencies also have instituted special bonding assistance programs. NASBP has established a website, **www.suretylearn.org**, to help orient small and emerging contractors to the bonding process. The site offers an online course ($25 registration fee) and free informational materials in the form of slide presentations, articles, checklists, and forms. The course, "Understanding Contract Surety Bonding: An Orientation Course for Small Contractors," provides information and resources about contract surety bonds and how small and emerging contractors can best position themselves to achieve surety credit. The course is available for anyone at any time and can be taken by a student at his/her own pace within a 12-month period after purchase. Each chapter concludes with review questions to help the student gauge how well he/she has comprehended the chapter's content.

TYPES OF SURETY BONDS

CONTRACT BONDS—BID OR PROPOSAL BONDS, PERFORMANCE BONDS, PAYMENT OR LABOR AND MATERIAL BONDS, MAINTENANCE BONDS, AND SUPPLY BONDS

These bonds are required by state or federal law for most public construction projects or by the project owner.

COURT BONDS—FIDUCIARIES

This type of bond is given by a Court Fiduciary to secure the faithful performance of fiduciaries' duties and compliance with the orders of the court having jurisdiction. Typical bonds within this category include Administrators, Executors, Guardians, Trustees Under Will, Liquidators, Receivers, and Masters.

COURT BONDS—JUDICIAL PROCEEDINGS

This type of bond is required when litigants seek to avail themselves of privileges or remedies that are allowed by law only upon condition that a bond with surety be furnished for the protection of the opposing litigant or other interested party. Typical bonds within this category include Injunction, Appeal, Indemnity to Sheriff, Mechanic's Lien, Attachment, Replevin, and Admiralty.

LICENSE AND PERMIT BONDS

This category consists of any bond required by state law, municipal ordinance, regulation, and in some instances, the federal government or its agencies, as a condition precedent to the granting of a license to engage in a particular business or the granting of a permit to exercise a particular privilege. In general, the terms "License" and "Permit" are used interchangeably. Typical bonds within this category include Contractors' License Bonds, Motor Vehicle Dealer Bonds, Securities Dealers' Blue Sky Bonds, Employment Agency Bonds, Health Spa Bonds, Grain Warehouse Bonds, Liquor Bonds, Cigarette Tax Bonds, and Sales Tax Bonds.

PUBLIC OFFICIAL BONDS

This type of bond guarantees the faithful performance of duty by a public official in a position of trust. Such bonds are given to comply with federal or state statutes and, therefore, guarantee whatever liability the statute imposes. Typical bonds within this category include Treasurers, Tax Collectors, Sheriffs, Constables, Judges, Court Clerks, and Notaries.

BONDS THAT PROTECT THE U.S. GOVERNMENT

Various agencies of the federal government require or accept surety bonds for a number of different obligations, such as Medicare and Medicaid Provider Bonds, Immigrant Bonds, Excise Bonds, Customs Bonds, and Alcoholic Beverage Bonds.

MISCELLANEOUS BONDS

This category includes other types of bonds that do not fall into the categories outlined above, such as Lost Securities Bonds, Lease Bonds, Bonds to Guarantee Payment of Utility Bills or Return of Borrowed Property, Bonds to Guarantee Employer Contributions for Union Fringe Benefits, and Workers' Compensation Bonds for Self-Insurers.

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.

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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.