

The Benefits of Surety Bonds to Lenders



Example of the Value of a Surety Bond on a Bank Financed Project

- Builder/Developer Undertook a \$200M Mixed Use Retail, Hotel and Residential Project
- Lender Required Surety Bonds on GC Contract
- Project Failed During Great Recession: 2008
- Bank Was Owed \$40M
- Surety and Bank Signed Inter-creditor Agreement
- Surety Funded GC Through Successful Completion of the Project
- Bank Loan Repaid First from Sell of Condominiums
- No Loss to Bank

Example of Lender Not Requiring Bonds

- \$175M Office/Retail Project
- Developer Acted as GC, No Bond, GC Not Prequalified, Project/GC Failed
- 60 Subs and Suppliers Not Paid in Full
 - Jobs Lost, Businesses Impaired
- Litigation for Years
- Banks Incurred Major Loss: Liquidated Unfinished Project at Significantly Reduced Value
- Eye Sore in Community for Years

Who Requires Bonds?



- Public Agencies
- Private Owners
- Lending Institutions
- General Contractors
- Subcontractors

Mandated on Public Works

FEDERAL

Heard Act (1894) & Miller Act (1935)

Require performance & payment bonds for public work contracts over \$150,000

STATE & LOCAL

“Little Miller Acts” (vary by state)

Require performance & payment bonds on state & local public works projects



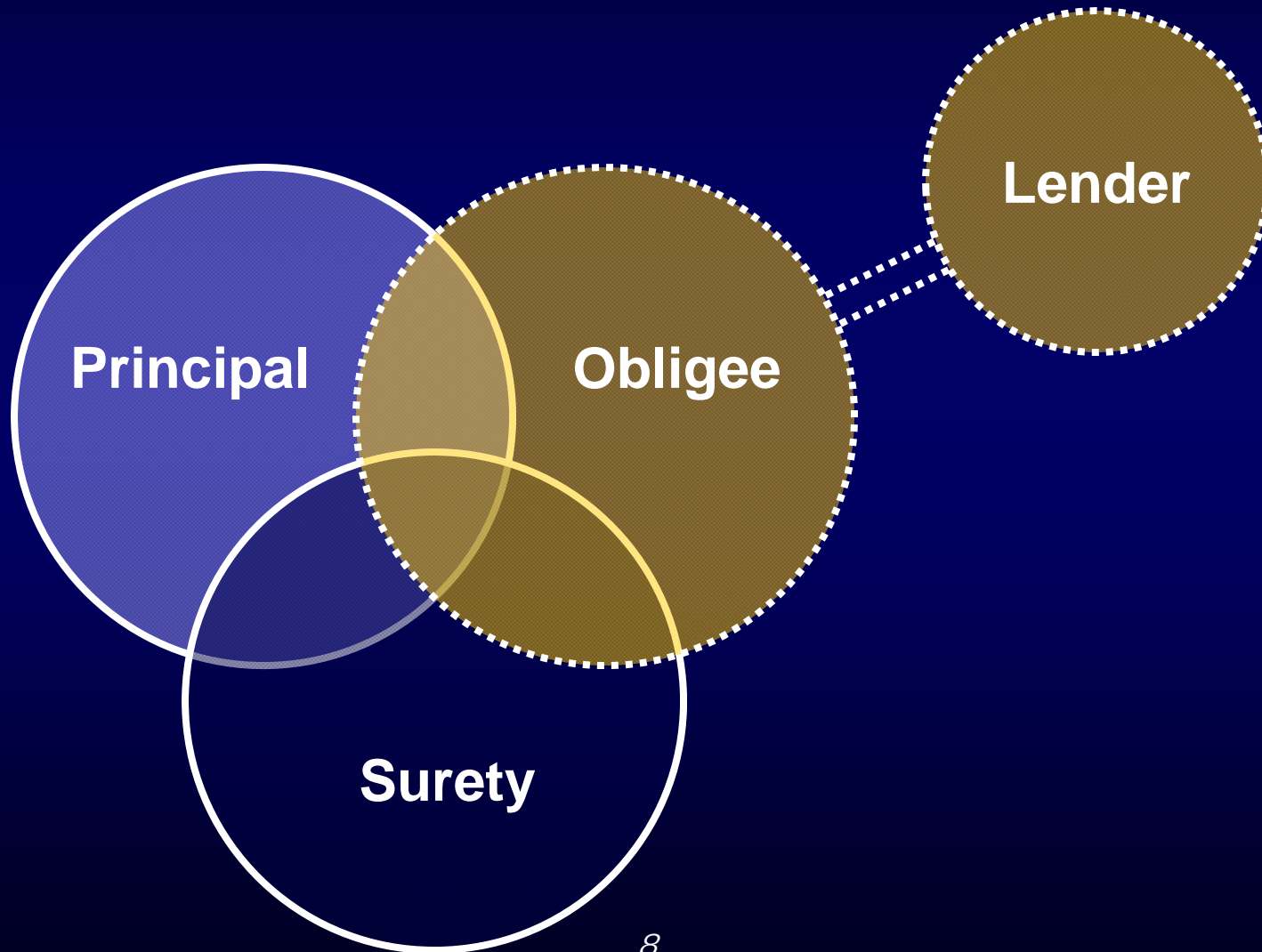
Why is Surety Required on Public Contracts?

- Protect Taxpayer's Money!

Why Should Bonds be Required on Private Commercial Projects?

- Protect The Lender's Money!

Parties to a Surety Bond



Lender as Dual Obligee

- Rider Added to General Contractor's Payment and Performance Bonds
- Creates Direct Rights Against the Surety Bond for the Lender, as Long as Contractor is Paid
- Normally No Additional Charges for the Rider by the Surety

Types of Contract Surety Bonds

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

AGC DOCUMENT NO. 262
BID BOND

Contractor, _____ (Name), has submitted a Bid to the Owner, _____ (Name), for _____ (Name), in accordance with the Bidding Documents, including _____ (Name) Architect/Engineer _____ (Name) Principal and _____ (Name)

PERFORMANCE BOND
(See instructions on reverse)

Public reporting burden for this collection of information is estimated to average 15 minutes per response, including reviewing the data provided, collecting existing data from other sources, gathering and maintaining the data needed, and completing and reviewing this collection of information, including suggestions for reducing the burden. Send comments to Washington, DC 20405

PRINCIPAL (Legal name and business address)

STATE BOND EXPOSURE

THE AMERICAN INSTITUTE OF ARCHITECTS

AIA Document A311

Labor and Material Payment Bond

THIS BOND IS ISSUED SIMULTANEOUSLY WITH PERFORMANCE BOND IN FAVOR OF THE OWNER CONDITIONED ON THE FULL AND FAITHFUL PERFORMANCE OF THE CONTRACT

KNOW ALL MEN BY THESE PRESENTS: that _____ (here insert full name and address or legal title of Contractor) as Principal, hereinafter called Principal, and _____ (here insert full name and address or legal title of Surety) as Surety, hereinafter called Surety, are held and firmly bound unto _____ (here insert full name and address or legal title of Owner), for the use and benefit of claimants as hereinbelow defined _____ Dollars (\$ _____)

- Bid Bond
- Performance Bond
- Payment Bond

Bid Bonds

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

AGC DOCUMENT NO. 262
BID BOND

Contractor, _____, has submitted a Bid to the Owner, _____, for _____, in accordance with the Bidding Documents, including _____ Architect/Engineer _____ Principal and _____

PERFORMANCE BOND
(See instructions on reverse)

THE AMERICAN INSTITUTE OF ARCHITECTS

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Labor and Material Payment Bond

THIS BOND IS ISSUED SIMULTANEOUSLY WITH PERFORMANCE BOND IN FAVOR OF THE OWNER CONDITIONED ON THE FULL AND FAITHFUL PERFORMANCE OF THE CONTRACT

KNOW ALL MEN BY THESE PRESENTS: that _____ here insert full name and address or legal title of Contractor

_____ here insert full name and address or legal title of Architect/Engineer

as Principal, hereinafter called Principal, and _____ here insert full name and address or legal title of Surety


as Surety, hereinafter called Surety, are held and firmly bound unto _____ here insert full name and address or legal title of Owner

Dollars (\$ _____)

- **Bid Bond (Public Bidding)**
 - Assures the Contractor's Bid was Submitted in Good Faith
 - Assures the Successful Bidder Will Enter into the Associated Final Contract
 - Indicates the Bidder has Been Pre-Qualified by a Surety

Performance Bonds

THE AMERICAN INSTITUTE OF ARCHITECTS



AIA Document A312

Performance Bond

Any singular reference to Contractor, Surety, Owner or other party shall be considered plural where applicable.

CONTRACTOR (Name and Address): _____ SURETY (Name and Principal Place of Business): _____

OWNER (Name and Address): _____

CONSTRUCTION CONTRACT
Date: _____
Amount: _____
Description (Name and Location): _____

BOND
Date (Not earlier than Construction Contract Date): _____
Amount: _____
Modifications to this Bond: None See Page 3

CONTRACTOR AS PRINCIPAL (Corporate Seal) _____ SURETY Company: _____ (Corporate Seal)

Signature: _____ Name and Title: _____ Signature: _____ Name and Title: _____

(Any additional signatures appear on page 3)

(FOR INFORMATION ONLY—Name, Address and Telephone)
AGENT or BROKER: _____ OWNER'S REPRESENTATIVE (Architect, Engineer or other party): _____

AIA DOCUMENT A312 - PERFORMANCE BOND AND PAYMENT BOND • DECEMBER 1984 ED. • AIA • THE AMERICAN INSTITUTE OF ARCHITECTS, 1735 NEW YORK AV. • N.W. • WASHINGTON, D.C. 20006
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A312-1984 1

- Performance Bond
 - Frequently Manuscripted by Obligee
 - Assures the Obligee (e.g. Owner, General Contractor, etc.) of the Principal's Compliance with the Underlying Contract
 - Can Include a Dual Obligee Rider to Protect the Lender

Payment Bonds

The image shows two overlapping forms. The top form is titled "THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA" and "AGC DOCUMENT NO. 262 BID BOND". It contains fields for Contractor, Owner, Architect/Engineer, and Principal. The bottom form is titled "THE AMERICAN INSTITUTE OF ARCHITECTS" and "AIA Document A311 Labor and Material Payment Bond". It includes a section for "KNOW ALL MEN BY THESE PRESENTS" and fields for Principal and Surety. Both forms have detailed instructions and legal clauses.

- Payment Bond
 - Assures the Obligee that Qualifying Subcontractors and Suppliers Will be Paid
 - Protects against Liens
 - Can Include a Dual Obligee Rider to Protect the Lender

Fundamentals of Surety Underwriting

**Capital
Capacity
Character**

Underwriting

Capital

Financial
Statements
Work-in-progress
Indemnity
Bank Relationship

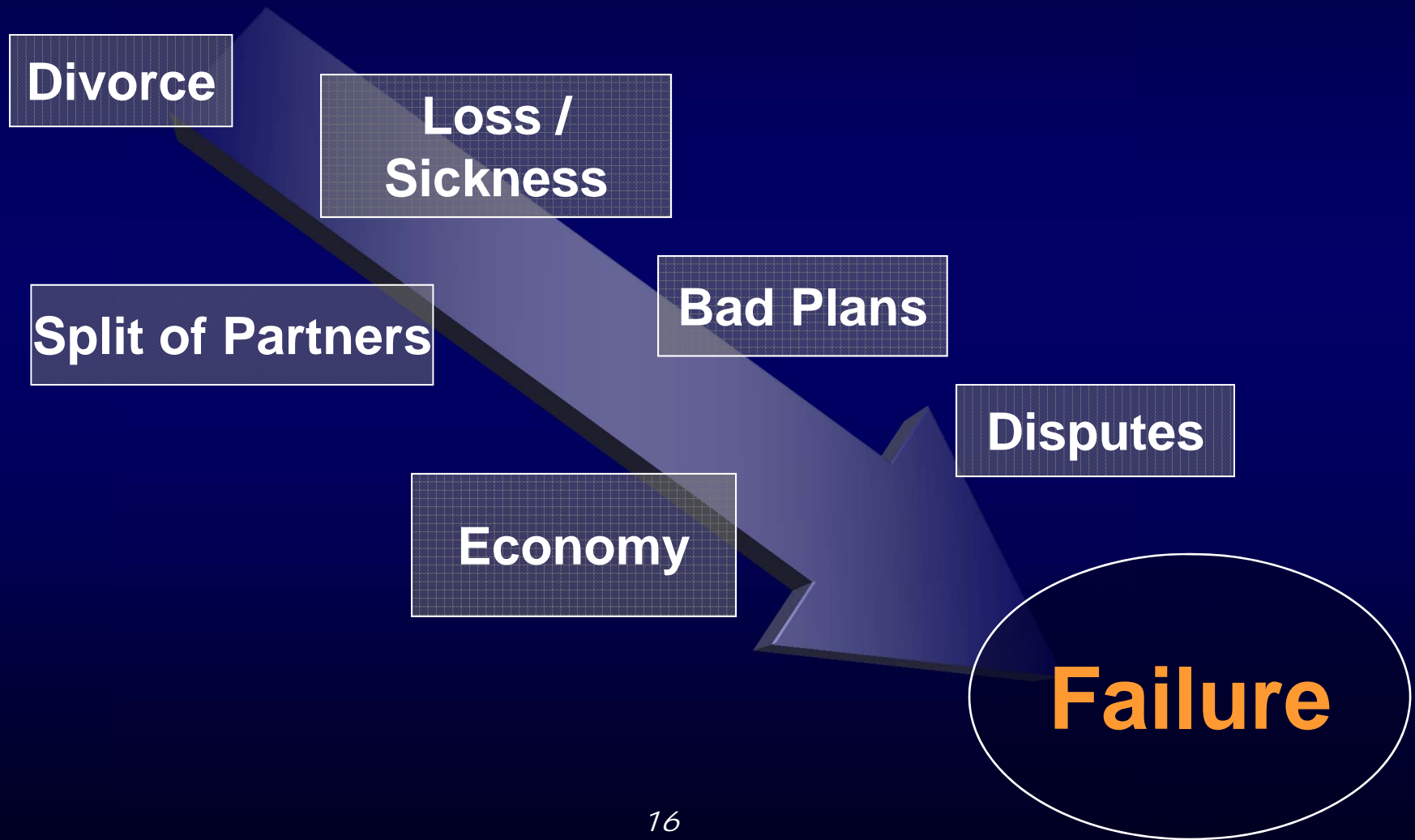
Capacity

Personnel
Experience
Equipment
Business Strategy

Character

Reputation
Relationships
References

Root Causes of Contractor Failures



Surety Bonds Protect Against the Unexpected

- Prequalification Cannot Predict
 - Failure of a Marriage
 - Death of a Loved One
 - Severe Economic Downturn
- Typically for Less Than 1% of the Contract Value, Surety Protects Against the Unexpected

Benefits of Bonds to Owners & Lenders

- Prequalification of General Contractor to Perform the Contract and Pay for Work
- Protects Against Liens
- Investigates, Evaluates and Mediates Disputes Between Owner and GC
- Pays to Complete Performance and Satisfy Payment Obligations

Other Benefits to the Lenders

- Protects the Value of the Lender's Collateral
 - The Value of a Completed Project Far Exceeds the Value of an Incomplete Project
- Protects Bank's Other Customers (Subs and Suppliers) from Uncollectable Receivables

Benefits to the Lenders & Community

- Protects Jobs for Employees of Contractors, Suppliers and Manufacturers
- Avoids a Blemish to the Reputation and Appearance of the Community

More Lenders Requiring Surety Bonds

Bill Minderjahn, V.P. of Surety for RT Specialty, LLC – A Leading Wholesaler of Specialty Insurance Products and Services- was Recently Quoted in the PropertyCasualty360 Magazine:

“There has been a trend of lending institutions requiring bonds in more instances to finance projects in the private sector”

Example of Lenders Requiring Bonds: Value Received

- \$96M Hotel, Retail, Housing Project
 - Builder/Developer: Lender Required Bonds
- Surety Provided Services Beyond Bond
 - Reviewed Plans and Specs
 - Helped Vet Major Subs, Req'd. Sub Bonds
 - Reviewed Estimate and Schedule in Detail
- Results: Project on Schedule, No Major Issues
 - Project Completion in 2017

Value of Bonds on Major International Project: Panama Canal

- Consortium of 4 Contractors, \$5B Contract
- Major Dispute Between GC & Owner Over Site Conditions and Contract Terms
 - Threatened to Shutdown Project
- Surety Arranged and Mediated Meeting with GC & Owner
- Interim Agreement Reached, Work Continued and Project Completed

Value of Surety on Bank Financed Project

- GC Built Drug Store and Bank Branch
- Lender Required Surety Bonds from GC
- Project Fell Behind Due to Unpaid Subcontractors
- Surety Funded GC Through Completion of Project
 - Paid Subs and Suppliers
 - Funded the Expediting of the Work
 - Monitored Progress Through Meetings with GC and Obligees
- Project Was Successfully Completed, Though Late, without Lien

Value of Bonds to Public Involving a “Disadvantaged” Contractor

- Minority Contractor “Graduated” to Federal Contracts
- Contractor was Unable to “Scale” to Larger Contracts
- Without the Obligees Declaring a Default, Surety Provided Financial Support to the Contractor on 11 Projects
- Surety Arranged and Funded Construction Expertise to Supplement the Minority Contractor
- Contractor Able to Successfully Complete the Projects at Significant Cost to the Surety

Value of Bonds on Major Public Highway Projects

- Long-Standing Heavy Highway Contractor Failed
- Significant Uncompleted Work on Major Interstates
- Surety Conducted Extensive Investigation and Evaluation of the Uncompleted Projects
- Selected a Replacement Contract with State
 - Project Could Not be Delayed by a Re-Bidding Process
- Entered Into a 3 Party Completion Agreement
- Project was Successfully Completed
- Surety Paid Excess Cost to Finish

Surety Preserving Value for Contractor's Lender

- Bridge Builder was Client of Surety and Bank
- Terminated on 3 Bridge Projects Valued at \$50M in Home State
- Surety Arranged and Financed a Completing Contractor
 - Used Key Employees and Labor from Defaulted Contractor
- Surety Funded Defaulted Contractor Through Completion of Other Remaining Backlog
 - Surety Kept Loans Current
- Surety Minimized Bank's Loss on Loans to the Contractor by Facilitating Orderly Liquidation of the Company

Frequent Misconceptions

- Large, Well Known Contractors Never Fail
 - Abengoa
 - Dick Corporation
 - Modern Continental
 - Guy F. Atkinson
 - J. A. Jones
 - Many Others
- Subcontractor Default Insurance (Purchased by the GC) Equals a GC Surety Bond

Surety Bond on GC vs. Subcontractor Default Insurance

- Lenders are being Told SDI Replaces the Need for a Surety Bond from the GC
- Developer/Lenders are Not Direct Beneficiaries of SDI
- SDI Indemnifies Only GC from Financial Failure of Only Scheduled Subcontractors
- SDI Offers No Protection to Developer or Lender from the Financial Failure of the GC
- SDI Does Not Provide Payment Protection to Subcontractors and Suppliers
 - Could Result in Lack of Progress on Project, Legal Disputes, Property Liens, and Other Problems

Surety Bond on GC vs. Subcontractor Default Insurance

- GC Surety Bonds Provide Direct Rights (with Dual Obligee Rider) to Developer and Lender Against the Surety
 - Guarantees Performance of Contract and Payment of Major Subs and Suppliers
 - Limits are Full Contract Value for Each, Performance and Payment
 - Covers Contractual Warranties
 - Covers the Financial Failure of the GC
- Surety Provides an Independent Assessment of the Ability of the GC to Successfully Complete the Project

Example of Coverage Gap in SDI Versus GC Surety Bond

- The San Antonio Water System (SAWS) Awarded a \$500MM Public Private Partner Contract to Abengoa for a New Water System Named Vista Ridge Pipeline
- Abengoa SA, a Huge International GC, Convinced SAWS and Lenders No GC Surety Bond Was Needed As Abengoa Would Buy SDI
- Lenders Advanced \$120MM, Abengoa Made Limited Progress on the Project Before Declaring Bankruptcy
- Lenders Have No Bond to Claim Against, and are Creditors in Bankruptcy
- SAWS Hired a New GC and is Now Requiring GC to Provide a Surety Bond

Subcontractors on the Use of SDI

- Tom Yocum, Chapter Attorney for the Greater Cincinnati Region of the American Subcontractors Association (ASA) and VP of the Ohio Chapter of the ASA states:

"Subcontractor Default Insurance (SDI) does not replace the need for payment and performance bonds by General Contractors. Many owners do not understand that SDI does not eliminate GC risk of default."

Subcontractors on the Use of SDI

- Attorney Yocum Further Comments on Subcontractor's Perception of SDI:
 - Does Not Protect Owner or Lender from GC Default
 - Does Not Protect Subcontractors and Suppliers from Non-Payment
 - Unpaid Subs and Suppliers May Lien Property
 - Lack of Payment May Force Subs into Default
 - Lack of Payment Could Slow the Progress of the Project

Subcontractors on the Use of SDI

- Attorney Yocum Also Notes:
 - If an Unbonded GC uses SDI Versus Requiring Subcontractor Bonds:
 - There is the Loss of the Independent Prequalification of the Subcontractors that are doing the Work on the Project
 - Some Good Subcontractors May Refuse to Enroll in SDI and thus Not Work on the Project due to the Loss of Confidentiality
 - Most Good Subcontractors Prefer to Provide Subcontractor Bonds Versus Enrolling in SDI

Conclusion

- Lenders Operate on Thin Margins: One Default Could Wipe Out 100 Good Loans
- Lenders' Underwriting is Based on Completed Projects: Success of Project and Value of Collateral
- Requiring Surety Bonds from GC's is an Economical Way to Assure Project Completion, Protecting the Bank's Collateral
 - SDI Does Not Replace the Need for Bonds from GC
- Sureties Prequalify GC's and Guarantee Payment of Subs and Suppliers
- Members of SFAA and NASBP are Available to Further Discuss the Value of Surety Bonds to Lenders

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