**Claims**
The manner in which the claims process is handled by sureties and banks also differs greatly.

**Surety Bonds**
- If the owner declares the contractor in default, the surety investigates.
- If the contractor defaults, the surety’s options are to:
  - Finance the original contractor or provide support;
  - Take over responsibility for completion (up to the penal sum of the bond);
  - Tender a new contractor; or
  - Pay the penal sum of the bond.
- With payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers up to the penal sum of the bond.

**Bank Letters of Credit**
- The bank will pay on an LOC upon demand of the holder if made prior to the expiration date.
- There is no completion clause in an LOC. The task of administering completion of the contract is left to the owner.
- The owner must determine the validity of claims by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.
**Surety Bonds or Bank Letters of Credit**

**Important Distinctions**

Construction project owners may use bank letters of credit (LOCs) to provide financial protection in the event of contractor default. However, completion of the construction project is the primary goal, and LOCs offer no such assurance. When it comes to limiting exposure to the inherent risks of construction, choosing the best form of risk management can make a big difference.

Contract surety bonds and LOCs provide similar financial protection; however, contract surety bonds have an edge when compared to LOCs and their effect on borrowing capacity, duration, coverage, cost, and claims and contractor prequalification.

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### Definitions

**Surety Bonds**
- A three-party agreement among the surety, the obligee (the project owner), and the principal (the contractor)
- A performance bond protects the owner from non-performance and financial exposures should the contractor default.
- A payment bond (a.k.a. labor bond and material bond) protects certain subcontractors, laborers, and material suppliers against non-payment by the contractor.

**Bank Letters of Credit**
- A bank LOC is a cash guarantee to the owner, who can call on the LOC on demand. The LOC converts to a payment to the owner and an interest-bearing loan for the contractor.
- The performance of the contract has no bearing on the bank’s obligation to pay on the LOC.

### How to Obtain

- **Surety Bond**: The contractor obtains the bond through a surety bond producer. A list of surety bond producers is available through the National Association of Surety Bond Producers (NASBP) at [www.nasbp.org](http://www.nasbp.org).
- **Letter of Credit**: The contractor obtains the LOC through a banking or lending institution.

### Cost

- **Surety Bond**: Generally 0.5% - 3% of the contract price (closer to 3% if the SBA Bond Guarantee Program is used). The bond is project-specific and covers the duration of the contract. The cost is included in the contractor’s bid price.
- **Letter of Credit**: Cost generally is 1% of the contract amount covered by the LOC (usually 5% - 10%)—e.g., if the LOC covers 10% of the contract, cost = 1% x (10% x contract amount) x years of contract. The cost is included in the contractor’s bid.

### Coverage

- **Surety Bond**: Performance bond – 100% of the contract amount for project completion
- **Letter of Credit**: The LOC may be obtained for any percentage of the contract, but 5% - 10% is typical.
- **Surety Bond**: Payment bond – 100% of contract amount protects certain subcontractors, laborers, and materials suppliers and protects private owner against liens.
- **Letter of Credit**: No protection/guarantee that subcontractors, laborers, and materials suppliers will be paid in the event of contractor default. They may file liens on private projects.

### Duration

- **Surety Bond**: Surety bonds remain in force for the duration of the contract plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.
- **Letter of Credit**: An LOC usually is date-specific, generally for one year. LOCs may contain “evergreen” clauses for automatic renewal, with related fees.

### Prequalification

- **Surety Bond**: A surety company assesses the contractor’s business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to verify that the contractor is capable of performing the contract. The purpose is to avoid default.
- **Letter of Credit**: The banker examines the quality and liquidity of the collateral in case there is a demand on the LOC. If the banker is satisfied that the contractor can reimburse the bank if demand is made upon the LOC, there is no further prequalification.

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<td>Specific liquid assets are pledged to secure bank LOCs. Bank LOCs diminish the contractor’s line of credit and appear on the contractor’s financial statement as a contingent liability. The contractor’s cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected.</td>
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