



Here is a behind-the-scenes look at surety bonds to take the uninitiated from A to S. Watch for T to Z in the next issue of *The RMA Journal*.

Mitigating Real Estate Construction Risk: How Surety Bonds Protect Borrowers and Bankers

As a construction lender, a banker's goal is simple—to be repaid on time, in full, and as agreed. In turn, satisfactory repayment depends upon successful project completion, and that requires contractors, workers, materials suppliers, and others to honor their commitments by completing the tasks on time, in full, and in agreement with what they were contracted to perform. One way to mitigate the real estate con-

struction risk and assure the successful completion of a construction project is by requiring bid, performance, and payment bonds as conditions of the loan.

The Surety Bond

A surety bond is a three-party agreement among the surety, the project owner, and the contractor. The surety assures the project owner (oblig-

ee) that the contractor (principal) is qualified and will perform a contract in accordance with the contract documents. Contractors frequently require their subcontractors to obtain bonds, in which case the contractor is the obligee and the subcontractor is the principal.

Not traditional insurance. A surety bond transfers the risk of contractor default from the project owner and lender to the surety company. If contractor failure does occur, it is the surety company that remedies the default—not the owner, nor the lender. The purpose of the bond is to protect the third party, the owner, and, indirectly, the owner’s lender from exposure to loss. The surety fully expects the principal to complete its obligations successfully. Unlike traditional insurance, the principal bears the economic risk of bond default and will have to reimburse the surety for any loss the surety must pay to the obligee.

Surety is essentially a surety’s extension of credit to a principal. Although bank credit fulfills many financial needs and uses a pre-qualification process to evaluate a borrower similar to the surety’s pre-qualification of a principal, the surety bond gives the principal the benefit of the surety company’s credit standing while also benefiting the obligee by guaranteeing the principal’s performance and monetary obligations.

Surety and other forms of insurance share some characteristics, but they differ in several significant ways. First, traditional insurance is a two-party agreement between the insurance company and the insured in contrast to the bond’s three-party agreement

Figure 1
Similarities and Differences Between Surety Bonds and Traditional Insurance

Surety Bonds	Traditional Insurance
Three-party	Two-party
Risk transfer	Risk transfer
Protect obligee	Protect insured
Regulated by state insurance departments	Regulated by state insurance departments
Project specific	Term specific
Penal sum	Policy limits
No expectation of loss	Calculated pooled risk

Figure 2
Other Types of Surety Bonds

Contract Bonds: Bid or Proposal Bonds, Performance Bonds, Payment or Labor-and-Material Bonds, Maintenance Bonds, Subdivision Bonds, and Supply Bonds. These contract bonds are required by state or federal law for most public construction projects or are specified by a project owner.

- The Maintenance Bond normally guarantees against defective workmanship or materials and obligates the contractor to perform maintenance or corrective work during a specified period.
- The Subdivision Bond guarantees to the city, county, or state that the contractor will finance and construct certain improvements such as streets, sidewalks, curbs, gutters, and sewer and drainage systems.
- The Supply Bond guarantees performance of a contract to furnish supplies or materials.
- The Completion Bond secures the performance of a contract regardless of whether the obligee pays in accordance with the contract terms.
- The Dual-Obligee Bond names an additional obligee, generally the lender, which enables the lender to invoke the performance features of the bond.

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 privileges or remedies 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*.

among the surety, obligee, and principal. Second, traditional insurance is designed to compensate the insured against unforeseen adverse events. The policy premium is actuarially determined based on aggregate premiums earned versus expected losses. Surety companies operate on a different business model. Surety is

designed to avoid loss. The surety prequalifies the contractor based on financial strength and construction expertise and guarantees to the obligee that the principal will perform its contractual obligations. Since the bond is underwritten with little expectation of loss, the premium is primarily a fee for pre-qualification services, although

Figure 3

What Surety Professionals Analyze

Financial Strength	Ability to Perform	Reputation With
<ul style="list-style-type: none"> • Annual & interim financial statements with accountant's opinion page (audit preferred) • Investment strategies • Cost control mechanisms • Work in progress & work completed (bonded & non-bonded) & financial performance of each • Cash flow (balance sheet, income statements, G&A expenses, accounts receivable & payable) • Net worth • Working capital • Bank & other credit relationships (line of credit) 	<ul style="list-style-type: none"> • Prior experience on similar projects • Equipment • Résumés of key personnel • Past, current, and future workload (bonded & non-bonded) • Business & continuity plan with growth & profit objectives • Organization chart • Management plan 	<ul style="list-style-type: none"> • Project Owners • Subcontractors • Suppliers • Lenders

sureties also use loss cost and severity studies. Finally, an insurance policy typically term specific and renewable, but a surety bond covers a specific project from start to finish.

Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk-transfer mechanisms regulated by state insurance departments. Both traditional insurance and surety have coverage limits. With insurance, this is known as the policy limit, and with surety it is referred to as the penal sum, the financial limit of the bond. Figure 1 summarizes the similarities and differences between surety bonds and traditional insurance.

Types of Bonds: Bid, Performance, and Payment

There are three basic types of contract surety bonds—the bid bond, the performance bond, and the payment bond. These are the

workhorse bonds in construction risk mitigation. Figure 2 describes other types of bonds.

Bid bond. The bid bond ensures that the contractor has submitted its bid in good faith, that the contractor intends to enter into the contract at the price bid, and that the contractor will provide the required performance and payment bonds. A bid bond also discourages unrealistic bids from contractors who may not be capable of performing the contract. If the contractor is awarded the contract but fails to enter into the agreement, the surety may be required to pay the difference between the awarded bid and the next lowest bid or pay the bond penalty, usually 5-10% of the contract amount.

Performance bond. The performance bond assures the owner that the contractor is capable and qualified to perform the contract and protects the owner from financial loss if the contractor fails to per-

form the contract in accordance with its terms and conditions. Generally, a performance bond includes a maintenance period to cover corrections of defects from faulty materials or workmanship for at least one year. For longer periods, a separate maintenance bond may have to be obtained.

Payment bond. The payment bond assures that subcontractors, suppliers, and workers will be paid. This protects an owner from mechanic's liens and so facilitates the takeout of a construction loan by permanent financing. As an added bonus, subcontractors and suppliers may offer better prices when they know they are assured payment protection. There usually is no extra cost for the payment bond when it is issued with the performance bond.

Prequalification

The fundamental concept of contract surety is that contractor default is avoidable. Surety companies and surety bond producers spend a great deal of time and expense in the underwriting process to qualify a contractor before issuing a bond. Since surety companies back their bonds with their own assets, they conduct a careful, professional, and rigorous prequalification review of the contractor.

A successfully completed construction project means the rigorous prequalification process did what it was supposed to—ensure a competent, qualified contractor on the project. An in-depth look at the contractor's entire business operation is done to determine the contractor's ability to meet current and future contractual and financial obligations. Basically,

underwriting is a look at the three Cs of prequalification:

1. Capital—evaluation of a contractor’s financial strength.
2. Capacity—analysis of a contractor’s ability to perform the contract.
3. Character—review of a contractor’s reputation.

These considerations are outlined in Figure 3.

The underwriter analyzes financial trends and tracks gross profits on open and closed projects to determine the validity of the financial reports.

A surety inquires into the contractor’s prior experience and whether the contractor has worked on similar projects. The surety reviews past, current, and future work loads, including both bonded and nonbonded projects. Can (or has) the contractor obtain(ed) the necessary equipment to perform the work? The answer to this question involves organizational charts and résumés of key employees. The surety analyzes the contractor’s business plan, growth/profit objectives, and bidding practices, and asks how the business will continue in the event of the principal’s or key employee’s death or disablement.

The surety also investigates business relationships with subcontractors, suppliers, project owners, and lenders to determine the contractor’s reputation in the industry. The surety also evaluates potentially distracting business commitments, such as property investments and side ventures.

Before a surety company will issue a surety bond, it must be satisfied that the contractor runs a well-managed, profitable enterprise, deals fairly, and performs

obligations as agreed. Because avoiding contractor default is key to surety success, surety companies and surety bond producers must be expert at spotting business practices and conditions that can lead to contractor failure.

Contractor Failure

Despite the surety’s rigorous prequalification process, construction remains a risky business, and even capable and well-established contractors remain vulnerable to the risk of failure. According to BizMiner, of 853,372 building (non-single-family), heavy/highway, and specialty trade contractors operating in 2002, only 610,357 were still in business by 2004—a 28.5% failure rate (Figure 4).

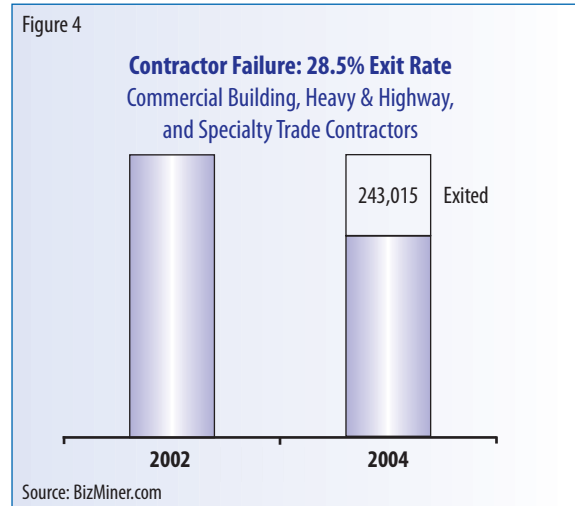


Figure 5

Why Contractors Fail

Accounting and Management	Labor and Material	Work Environment
<ul style="list-style-type: none"> • Inadequate financial, accounting, and project management systems • Change in ownership and/or personnel • Change in scope of business • Rapid overexpansion (volume and/or territory) 	<ul style="list-style-type: none"> • Subcontractor failure • Nonbonded subcontractors/selective bonding of subcontractors • Labor and/or material shortages • Cost escalations 	<ul style="list-style-type: none"> • Onerous contract terms and conditions • Unexpected economic downturn • Inclement weather

The Surety Association of America (SAA) reports that the surety industry paid \$180 million in losses on private construction in 2003, a 52.7% loss ratio. Private construction projects showing especially heavy losses included airports, industrial, landscaping and golf courses, and roofing. From 1998 through 2003, the surety industry paid nearly \$1 billion on private construction and \$5 billion in losses on bid, performance, and payment bonds on both public and private construction. Figure 5 summarizes the primary reasons behind contractor failure—accounting and management issues, labor and materials issues, and work environment issues.

Once notified of a default, the surety company independently investigates notices of disputes or claims and gives the obligee its assessment.

When a bonded contractor fails, the surety is legally obligated to the project owner and the contractor. Loss recovery requires knowing how the claims process works.

Claims

In a claims situation, the surety company must first investigate the claim in order to protect the contractor's legal recourse against an improper declaration of default. To expedite the claims process, default should be clearly defined in the contract, and the owner should communicate regularly with the contractor and the surety company. Once notified of a default, the surety company independently investigates notices of disputes or claims and gives the obligee its assessment. The investigation must be impartial and responsible in order to meet state standards as well as their own company service requirements.

The project owner can manage the claims process as well as lessen the risk of claims by taking the following steps:

- Verify the validity of the bond before awarding the contract.

- Notify the surety of changes in the contract.
- Know who to contact at the surety company.
- Notify the surety as soon as problems occur on the project.
- Allow the contractor time to cure the default before termination, if possible.
- Notify the surety company in writing and ask for a specific response if a potential default arises.
- Be reasonable and diligent in providing notice of default.



- Request a face-to-face meeting to discuss the complaint.
- Provide records and correspondence to the surety company.

If the surety company's investigation finds that the contractor has defaulted on the project under the performance bond, the

surety company may take one of the following actions, depending on the bond form and the specific facts of the case:

- Re-bid the job for completion.
- Arrange for a replacement contractor.
- Retain the original contractor and provide trained personnel and/or financial assistance.
- Reimburse the owner by paying cost of completion, up to the penal sum of the bond.

If its investigation determines that the contractor is not in default, the surety company is not obligated to perform. The Associated General Contractors (AGC) of America has published an overview of the surety bond claims process and useful information on what to expect in a claims situation.

This booklet is available from the Surety Information Office (www.sio.org or 202-686-7463) at no charge.

Requiring a Bond

Requiring a bond for a project is easy. As a condition of the loan, the owner simply states the

requirement in the contract specifications. It is the contractor's responsibility to contact a surety bond producer and obtain the necessary bonds. The contractor submits the bond to the owner; the lender also should request a copy of the bond.

Read the bond form carefully to understand its provisions as well as the surety's responsibilities and liabilities. Be sure that all data is entered correctly and that it is signed and dated.

The bond form should stipulate the parties to the bond, indicate the surety company's maximum financial obligation—known as the "penal sum" of the bond, state the surety company's obligations under the bond, include the construction contract and specifications by reference, provide a brief description of the project, and give the location of the project.

The lender can add a dual-obligee rider to the bond in order to name the bank as an additional obligee. Once named, the bank has the right to invoke the performance features of the bond. If the project owner defaults, the dual-obligee bond enables the lender to take over the project from a defaulting owner. The dual-obligee bond allows the lender to make a claim on the bond, and it doesn't diminish a lender's right to take over the contract.

The owner is responsible for paying the bond premium, which the contractor includes in the bid price. The bank should verify that the surety is licensed to do business in the state where the project is located, is financially stable, and is knowledgeable about the contractor it is bonding. The bank should also make certain the

owner is following business procedures and notice requirements, as well as paying the contractor on time.

On bonded projects, an owner's duties include providing complete and detailed plans and specifications, paying the contractor in full and on time, securing financing in advance of letting the contract, and minimizing red tape in handling requisitions. Failure to pay a contractor can cause cash flow problems and is a breach of the contract. Additionally, it is advisable for the owner to communicate regularly with the contractor and surety and verify the validity of the bond.

Advantages of bonding.

When analyzing the risks on a particular project, such as project scope and complexity, contract dollar amount, and familiarity with the contractor, consider how surety bonds protect against those risks. When a surety company bonds a contractor, owners and bankers enjoy these protections:

- 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 nonbonded projects since the surety company may hold personal or corporate indemnity.
- Exposure of mechanic's liens

Figure 6

Guidelines for Requiring a Bond as a Condition for a Loan

Establishing parameters for requiring bonds is an excellent way to help manage the risks associated with loans on construction projects. Some guidelines include:

- Projects with significant construction risk (new, unusual, technical, very short or very long construction schedule).
- When using low bidder, project delivery method is new to owner, or using CM at Risk.
- Contractor or subcontractors involved (not familiar with project team or a sole-source sub or supplier).
- Projects that exceed certain dollar amounts (bonding threshold).

Figure 7

Approximate Cost of Bonds

Contract Amount	Bond Premium
\$100,000	\$1,200 - \$2,500
\$1 Million	\$7,700 - \$13,500
\$10 Million	\$56,950 - \$81,000
\$50 Million	\$206,475 - \$341,000

Rates may vary depending on the size and type of the project and the contractor's bonding capacity. These rates are approximate and are intended to provide examples of the range of rates an owner might expect.

by unpaid subcontractors and suppliers is transferred when a payment bond is in place.

- The surety has claims-paying strength.
- Surety companies may offer technical, financial, or management assistance to a contractor in order to prevent default.
- Risk concentration and lender liability are reduced.
- The surety company performs the obligations of the contractor in the event of contractor default.

Figure 6 offers some guidelines for when to require a bond as a condition for a loan.

A senior real estate lender recalled one project several years ago that demonstrates the value of surety bonds. “We were financing the development of a retail project with a large, well-known discount department store that likes to get into its projects in October so they can benefit from the Christmas season. We did have a bonded contractor on that job, and when the general contractor encountered financial difficulties, the bonding company stepped in and worked with the owner to replace that general contractor so that we were able to get that anchor tenant in on time for that particular season.”

Cost of bonding. What is the cost of the protection afforded by a surety bond? The price or premium for a bond normally ranges from 0.5% to 2.5 % of the contract amount, depending on the size and type of the project and the contractor’s bonding capacity. The premium usually includes the bid, performance, and payment bonds

plus a one-year warranty period. The premium is a one-time fee for an underwriting service that prequalifies a contractor as financially sound and capable; able to complete the project; as well as capable of providing financial protection for subcontractors, suppliers, and workers. Some examples of bond costs for different contract sizes are shown in Figure 7.

Other conditions and covenants. In addition to requiring a bond, the banker should also consider these conditions and covenants:

- The surety must be acceptable to the bank, and one way to define acceptability is to employ the Best’s Insurance Rating to set a minimum rating—say, “A” or better.
- Loss of bonding is an event of default.
- The bank is to be copied on all financial information provided to the bonding company.

These requirements recognize the importance of bonding to the borrower, and, in effect, cross-

default the borrower’s bonding company compliance to the bank. If a contractor is heavily reliant on bonding construction work to repay the bank, these covenants link access to bonding with repayment ability.

Summary

Bonding has evolved over the years as a proven, reliable method of mitigating the potential misfortunes of real estate construction risk. The purpose of this article has been to show how both bankers and borrowers benefit from bonding provided by sureties. This commonsense approach to spreading risk helps all three parties beat the odds of construction risk. □

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