The Surety Safeguard:

How Bonding Protects Taxpayer Dollars

The Surety Safeguard

More than 80,000 contractors have failed from 1990-1997, leaving a trail of unfinished private and public construction projects with losses of nearly $22 billion, according to Dun & Bradstreet's *Business Failure Record.* Yet there was no need for a government bailout on uncompleted public works projects. Taxpayers were protected against virtually all losses caused by contractor failure.

That's because surety bond companies provided the resources necessary to complete the projects 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 bond company.

When a government entity awards a construction project to the lowest bidder, it knows that the surety bond company stands behind the contractor's promise to complete the job according to the owner's specifications and terms of the contract.

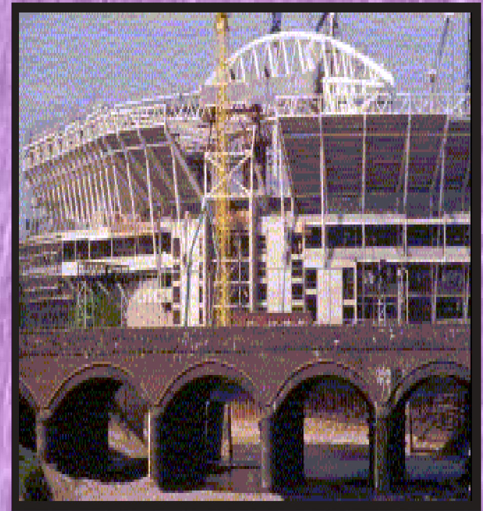
A Long History

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 who 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."



When a government entity awards a construction project to the lowest bidder, it knows that the surety bond company stands behind the contractor's promise to complete the job according to the owner's specifications and terms of the contract.

Today, surety bonds protect almost every public construction project across the country. In 1997, nearly $160 billion in public works projects were under construction throughout the United States with surety bonds providing valuable protection against contractor failure.

Why Bonds?

One-half of all construction firms in business today will not be in business six years from now, according to the Associated General Contractors, a construction industry trade association. Anyone familiar with the construction industry knows there is a long list of potential problems that 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.

No construction project owner—public or private—can gamble on an unreliable contractor who could go bankrupt halfway through the job. A state highway department, for example, wants to be sure that the contractor hired to build a new bridge will be technically competent and financially fit. This state agency has an added concern: how can it be sure the lowest bidder—with whom it must contract under the low-bid system used in awarding most public works contracts—will be dependable and not cause a drain on state taxpayers' money?

Surety Bonds Protect Public Funds

This essential assurance to the public is provided by bid, performance, and payment bonds.

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.

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, it was completed ahead of schedule.

The surety's Large Loss Team, comprising 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."

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 back of this booklet.

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's 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. 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.

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 that the contractor will pay certain laborers, material suppliers, and subcontractors. That's why surety bond underwriters analyze applicants closely. They must be certain that only those who can successfully complete a particular job receive a bond, and withhold bonding from those who cannot. To bond all contractors regardless of their abilities makes the prequalification process useless and would, in fact, increase contractor defaults.

Before issuing a bond, the surety underwriter must be fully 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's essential that the contractor has the experience that matches the requirements of a specific construction project; someone who has

Surety's Quick Thinking Keeps Subs Paid and On the Job

A contractor hired by a local government to construct a municipal building abandoned the project with 75% of the structure completed. Since the contractor defaulted, the owner called upon the surety to arrange for completion.

The surety's investigation determined that the contract with the contractor had been properly terminated due to abandonment of the project and non-performance. In order to meet its obligations, minimize loss, cost, and expense, the surety hired (at its own expense) a construction management consultant to assist with the claim.

It was imperative for the surety to respond quickly since the structure would suffer extensive damage if not completed before winter weather set in.

The surety and management consultant determined the condition of the work site, quality of work completed, and the new projected completion date. The surety expedited the project by using the original subcontractors and suppliers on the project.

The surety hired a field superintendent to monitor the work site. The surety and architect reviewed payment claims and convinced the project owner to pay subcontractors and suppliers for unpaid work. Within four weeks of the subs returning to the job site, the municipality obtained a Substantial Completion Certificate and was given partial occupancy. The full Certificate of Occupancy was given to the owner four weeks later.

Cost to complete the building was $356,034. Liquidated damages of $22,500 and potential cold weather damage to the building was avoided. The surety's loss was $46,379.

built only driveways would not qualify for bonds 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 subcontractor s 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 help 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.

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.

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 one to three percent of the contract price and on large projects is often less than one percent.

The premium is a fee for underwriting services and stands for:

- a qualified contractor who is financially sound and capable;
- project completion;
- the surety's expertise and assistance;
- financial protection for subcontractors, suppliers, and laborers; and
- financial backing of the contractor.

It's 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.

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 possessed by professional surety bond companies. 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 will either pass or fail based on a set of fixed criteria—and if rejected, there is 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

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 nor 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 to complete the contract to VDOT's satisfaction.

companies that have surety bond departments and provide other types of insurance coverages 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 usually must file financial and other information with the Treasury Department and pass the Department's financial analysis. Surety bond companies that don't meet these standards can be removed from the list. The Treasury List may be downloaded from the Internet at

Availability of Surety Bonds

Surety bonds are available to contractors of all sizes. It's 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's 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.

Helping Small Contractors

Government also is playing a role in making surety bonds available. In an effort to maximize the opportunities for small contractors who 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 who do not qualify for bonds under the companies' normal underwriting standards.

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 whose 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! 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.

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

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. The U.S. Department of Transportation also has devised various programs to assist disadvantaged contractors.

A number of states also have enacted bond guarantee programs for contractors. Other state departments and agencies have instituted special bonding assistance programs as well.

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 which 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 Organizations

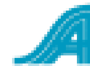
The Surety Association of America (SAA) and the National Association of Surety Bond Producers (NASBP) believe that all contractors, regardless of size, are entitled to a fair review of their bonding application by knowledgeable and professional surety bond producers and companies. SAA and NASBP are committed to educating contractors on how to obtain bonds. A valuable educational tool for contractors and subcontractors is *Your First Bond,* a videotape and brochure produced by SAA and NASBP, which provides an overview of what contractors need to do to apply for bonds. The Surety Information Office also has materials available at no charge that explain the benefits of contract surety bonds.

Contractors who believe they've been denied bonds unfairly may contact either SAA or NASBP for a review if they provide the details of their efforts to obtain bonds.

For more information about contract surety bonds contact:

Surety Information Office
5225 Wisconsin Ave., NW #600
Washington, DC 20015-2014
(202) 686-7463
Fax: (202) 686-3656
www.sio.org • sio@sio.org

The information source on contract surety bonds. SIO is supported by SAA and NASBP.



The Surety Association of America
1101 Connecticut Ave., NW #800
Washington, DC 20036
(202) 463-0600
Fax: (202) 463-0606
www.surety.org
information@.surety.org

SAA is a voluntary, non-profit, unincorporated association of companies engaged in the business of suretyship. If presently has approximately 600 member surety companies, which collectively underwrite the overwhelming majority of surety and fidelity bonds in the US, and 7 foreign affiliates. SAA is licensed as a rating or advisory organization in all states, DC, and Puerto Rico, and has been designated by all state insurance departments except Texas as a statistical agent for the reporting of fidelity and surety experience.

National Association of Surety Bond Producers
5225 Wisconsin Ave., NW #600
Washington, DC 20015-2014
(202) 686-3700
Fax: (202) 686-3656
www.nasbp.org • info@nasbp.org

NASBP is the international organization of professional surety bond producers and brokers. NASBP represents over 5,000 personnel who specialize in surety bonding, provide performance and payment bonds for the construction industry, and issue other types of surety bonds for guaranteeing performance, such as license and permit bonds. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.