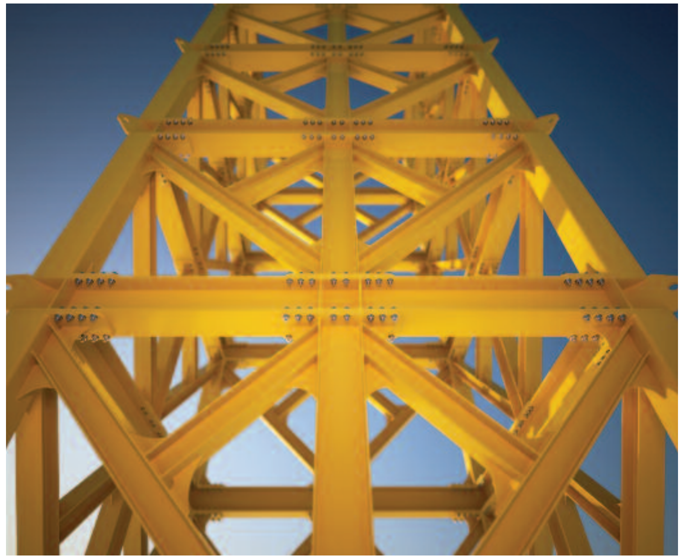
construction contractors, and special trade contractors operating in 2009, only 702,618 were still in business in 2011—a 21.72% failure rate. Despite the surety's rigorous prequalification process and best judgment about the qualifications of the contractor, sometimes contractor default is unavoidable. However, when a contractor fails on a bonded project, it is the surety company that remedies the default—not the project owner and not at taxpayers' expense.

In the unfortunate event that a bonded contractor does default, the surety has legal obligations to the project owner and the contractor. First, the owner must formally declare the contractor in default. Then the surety company conducts an impartial investigation before settling any claim. This protects the contractor's ability to pursue legal recourse in the event that the owner improperly declares the contractor in default. When there is a proper default, the surety's options often are spelled out in the bond. These options may include the right to re-bid the job for completion, bring in a replacement contractor, provide financial and/or technical assistance to the existing contractor, or pay the penal sum of the bond.



Bond Rates

Surety bond premiums vary from one surety to another, but can range from 0.5% to 2% of the contract amount, depending on the size, type, and duration of the project and the contractor. Typically, there is no direct charge for a bid bond. In many cases, a performance bond incorporates the payment bond and a maintenance period.

The contractor includes the bond premium amount in the bid and the premium generally is payable upon execution of the bond. If the contract amount changes, the premium may be adjusted for the change in contract price. Contract surety bonds are a wise investment—protecting public owners, private owners, lenders, and prime contractors from the potentially devastating expense of contractor and subcontractor failure.

Benefits of Bonds

After analyzing the risks involved with a construction project, consider how surety bonds protect against those risks. Owners, lenders, taxpayers, contractors, and subcontractors are protected because:

- 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 non-bonded projects since the surety company may require personal or corporate indemnity from the contractor;
- Subcontractors have no need to file mechanic's liens on a private project when a payment bond is in place, and because mechanics' 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;
- Bonding capacity can increase a contractor's or subcontractor's project opportunities;
- The surety bond producer and underwriter may be able to offer technical, financial, or management assistance to a contractor; and
- The surety company fulfills the contract in the event of contractor default.

Any contractor—whether in business for one year or 100, large or small, experienced or novice—can experience serious problems. Through the years surety bonds have held fast as a comprehensive and reliable instrument for minimizing the risks in construction.

Surety Information Office (SIO)

www.sio.org
sio@sio.org

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.

National Association of Surety Bond Producers (NASBP)

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info@nasbp.org

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.

The Surety & Fidelity Association of America (SFAA)

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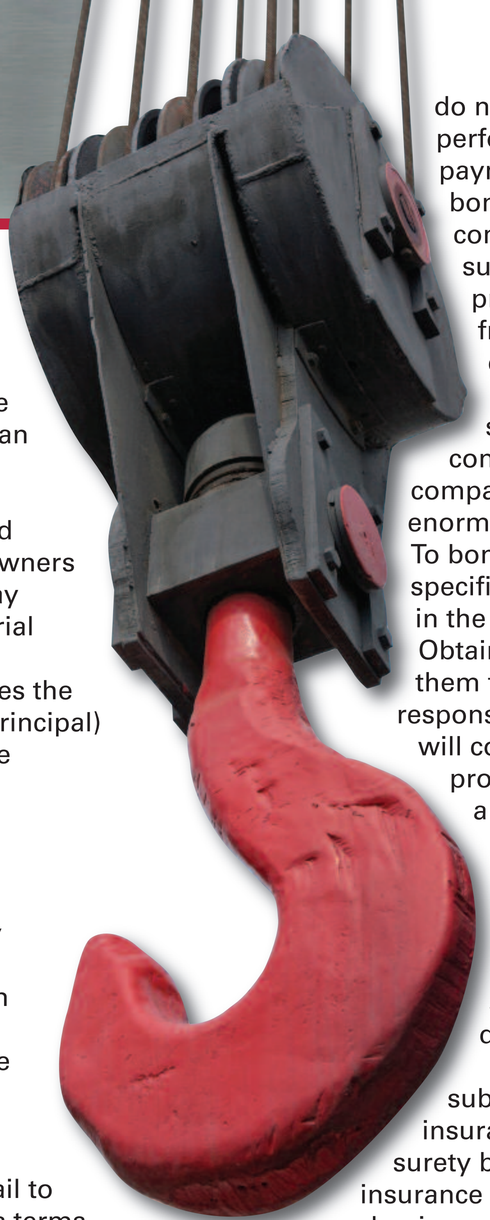
The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory 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.

The Importance of Surety Bonds

In Construction

The Importance of Surety Bonds in Construction



Historical Perspective

Surety bonds have been a valuable tool for centuries. The first known record of contract suretyship was an etched clay tablet from the Mesopotamian region around 2750 BC. According to the contract, a farmer drafted into the service of the king was unable to tend his fields. The farmer contracted with another farmer to tend them under the condition they split the proceeds equally. A local merchant served as the surety and guaranteed the second farmer's compliance.

Suretyship was addressed in the first known written legal code, the Code of Hammurabi, around 1792-1750 BC. A Babylonian contract of financial guarantee from 670 BC is the oldest surviving written surety contract. The Roman Empire developed laws of surety around 150 AD that exist in the principles of suretyship today.

While suretyship has a long history, it wasn't until the 19th century that corporate surety bonds were used. Recognizing the need to protect taxpayers from contractor failure, Congress passed the Heard Act in 1894, which required surety bonds on all federally funded projects. The Miller Act of 1935 (40 U.S.C. Section 270a et. seq.) was the last major change in public sector surety, and is the current federal law mandating surety bonds on federal public works. It requires performance bonds for public work contracts in excess of $100,000 and payment protection, with payment bonds the preferred method, for contracts in excess of $25,000. Almost all 50 states, the District of Columbia, Puerto Rico, and most local jurisdictions have enacted similar legislation requiring surety bonds on public works. These generally are referred to as "Little Miller Acts."

Risky Business

How one evaluates and manages risk on construction projects and makes fiscally responsible decisions to ensure timely project completion is key to success. To gamble on a contractor whose level of commitment or qualification is uncertain or who could become bankrupt halfway through the job can be a costly decision. How can a public agency using the low-bid system in awarding public works contracts be sure the lowest bidder is dependable? How can private sector construction project owners manage the risk of contractor failure?

Surety bonds provide financial security and construction assurance by assuring project owners that contractors will perform the work and pay specified subcontractors, laborers, and material suppliers. A surety bond is a risk transfer mechanism where the surety company assures the project owner (obligee) that the contractor (principal) will perform a contract in accordance with the contract documents.

Types of Bonds

There are three basic types of contract surety bonds:

- The bid bond assures that the bid has been submitted in good faith and that the contractor will enter into the contract at the price bid and provide the required performance and payment bonds.
- The performance bond protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- The payment bond assures that the contractor will pay specified subcontractors, laborers, and material suppliers on the project.

Financial Security & Construction Assurance

Although surety bonds are mandated by law on public works projects, the use of surety bonds on privately owned construction projects is at the owner's discretion. Alternative forms of financial security, such as letters of credit and self-insurance, do not provide the 100% performance protection and 100% payment protection of surety bonds nor do they assure a competent contractor. With surety bonds, the risks of project completion are shifted from the owner to the surety company. For that reason, many private owners require surety bonds from their contractors to protect their company and shareholders from the enormous cost of contractor failure. To bond a project, the owner specifies the bonding requirements in the contract documents. Obtaining bonds and delivering them to the owner is the responsibility of the contractor, who will consult with a surety bond producer. Subcontractors may also be required to obtain surety bonds to help the prime contractor manage risk, particularly when the subcontractor is a significant part of the job or a specialized contractor that is difficult to replace.

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. However, 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 prevent loss. The surety prequalifies the contractor based on financial strength and construction expertise. The bond is underwritten with little expectation of loss.

Prequalification of the Contractor

Sureties are able to accept the risk of contractor failure based on the results of a thorough, rigorous, and professional process in which sureties prequalify the contractor. This prequalification process is an in-depth look at the contractor's business operations. Before issuing a bond the surety company must be fully satisfied that the contractor has, among other criteria:

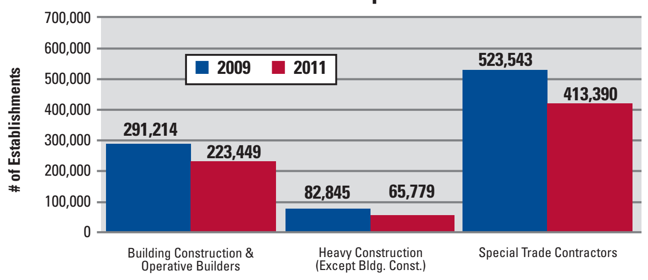
- Good references and reputation;
- The ability to meet current and future obligations;
- The experience matching the contract requirements;
- The necessary equipment to do the work or the ability to obtain it;
- The financial strength to support the desired work program;
- An excellent credit history; and
- An established bank relationship and line of credit.

The surety company must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly, and performs obligations in a timely manner. Surety bonds have played an important role in the construction industry's success, allowing the industry to sustain its position as one of the largest contributors to the nation's economic stability and growth.

Contractor Failure

Construction is a risk-filled enterprise, and even capable and well-established contractors can ultimately fail. According to BizMiner, of the 897,602 general contractors and operative builders, heavy

Construction Companies 2009-2011



Source: BizMiner (2012)
Failure rates track the actual experience of business establishments, firms, small businesses, branches and startups doing business at the start of the time series, and still in operation today.