National Association of Surety Bond Producers

# ANSWERS TO 32 QUESTIONS PUBLIC AND PRIVATE OWNERS ASK ABOUT CONTRACT BONDING

A SuretyLearn Publication

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## PUBLIC AND PRIVATE OWNERS ASK ABOUT CONTRACT BONDING

The National Association of Surety Bond Producers (NASBP) is a national trade association, headquartered in Washington, DC, comprised of agencies employing surety bond producers placing bid, performance, payment, and warranty bonds on federal, state, local, and private projects in the United States and around the world.

Surety bonds provide critical guarantees and security for owners of construction projects and many of the subcontractors that supply labor and materials for those projects. Surety bonds are unparalleled, proven risk management mechanisms that help ensure public and private construction projects are properly built and that certain subcontractors and suppliers are paid.

NASBP is aware that surety bonds can be complex and that many stakeholders in the construction industry, including owners, understandably have misconceptions about the nature and purpose of surety bonds. Sometimes those misconceptions result from lack of sufficient knowledge, and sometimes those misconceptions result from unintended misdirection.

NASBP is determined to try to eliminate those misconceptions for the benefit of the construction and surety industries and public and private owners by creating a series of questions and answers that address surety bonds.

To contact a professional surety bond producer, go to the NASBP membership directory on the NASBP website, **nasbp.org**, and click on **"GET A BOND"** and then **"FIND A PRODUCER."** The producers are listed by state.The National Association of Surety Bond Producers (NASBP) is a national trade association of bond producer agencies, whose employees are experts in surety. If you have any questions, please contact NASBP at 202.686.3700.

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### 1 What is a surety bond?

A surety bond is a promise to be liable for the debt, default,or failure of another.

A surety bond is a three-party contract by which one party (the surety) guarantees the performance of a second party (the principal) to a third party (the obligee). Surety bonds that are written for construction projects are called contract surety bonds.

The **surety** is an insurance company licensed by a state department of insurance to provide surety bonds to guarantee the performance of a principal.

The **principal** is the entity (in construction, the contractor, subcontractor, or supplier) that qualifies for the bond. It is the principal's obligation that the surety guarantees.

The **obligee** is the entity with whom the principal has a contract and to whom the bond is given. In construction this is the project owner or the prime contractor.

If the owner is the bond obligee, then the prime contractor is the principal. If the prime contractor is the obligee, then the subcontractor is the principal.

### 2 Are surety bonds like traditional insurance policies?

No. Surety bonds are almost always written by insurance companies that are licensed by state insurance departments, but they are not like traditional insurance policies. Surety bonds are three-party agreements, and traditional insurance policies are two-party agreements, such as life insurance or property insurance policies. The surety does not "assume" the primary obligation but is secondarily liable, if the principal defaults on its bonded obligation.

A surety does not expect to suffer losses because the surety expects the bonded principal to perform its contractual obligations AND the surety has a signed indemnity agreement from the contractor to protect the surety from any losses the surety suffers as a result of having issued bonds.

## 3 What are contract surety bonds?

Bonds written by an insurance company for construction projects are referred to as contract surety bonds. The main types of contract surety bonds are: bid bonds, performance bonds, payment bonds, and warranty bonds (sometimes called maintenance bonds).The two basic functions of these bonds are:

- **Prequalification—**assurance that the bonded contractor is qualified to perform the contracted obligation
- **Financial protection—i**f the contractor defaults on its obligation, guarantee that the contract will be performed and certain laborers and suppliers will be paid for work and materials

## 4 Where do contractors and subcontractors obtain bonds?

To obtain bonds, contractors and subcontractors contact a professional surety bond producer.

Bond producers are business professionals who specialize in providing surety bonds to contractors, subcontractors, material suppliers, and other construction project participants. They are knowledgeable about the surety and construction markets and focus their activities on the surety market and on positioning construction firms to qualify for surety credit. They provide invaluable business advice and expertise to assist a contractor in securing surety credit.

They obtain from the contractor extensive information and documentation needed to evaluate a request to bond a contract. The information and documentation is likely to include the following:

- Past 3 fiscal year-end financial statements
- Current interim financial statement and aged receivables and payables report
- Copies of bank loan agreements, including lines of credit
- Current personal financial statements on closely held company owners
- A current statement of work-in-progress report
- Resumés of owners/key employees
- Letters of recommendation
- Evidence of current insurance coverages
- A contractor's questionnaire, covering detailed personal and company information
- Copies of contracts the contractor is interested in bonding

A surety evaluating the issuance of bonds for a contractor reviews and analyzes this information. Bond producers nurture an ongoing relationship between the contractor and the surety company. They develop and maintain a relationship of trust, commitment, respect, and teamwork. This relationship continues throughout the period that the contractor maintains surety credit, as each bond issued is separately underwritten.

## 5 What is a bid bond?

A bid bond provides financial protection to the obligee (who can be the owner when the general contractor provides the bond, or the general contractor when the subcontractor provides the bond) if a bidder is awarded a contract but fails to sign the contract or provide the required performance and payment bonds. The bid bond also helps to screen out unqualified bidders, as a surety will not issue a bid bond on behalf of a contractor that it believes cannot fulfill the contract obligations of a construction contract. Prequalification means that the surety has investigated the contractor and determined that the contractor has the ability to carry out the work under the construction contract.

The surety's specific obligation under the bid bond is set forth in the bond itself. The surety is usually obligated to pay the owner the cost of having to repeat the bidding process if the awarded bidder is unable or unwilling to perform. The surety's liability is generally limited to the face amount, or penal sum, of the bond, which is typically in the range of 5 to 20 percent of the contract bid price. Sometimes, however, owners require a forfeiture bid bond, which requires the surety to pay the owner the entire penal sum of the bond. Sureties are generally reticent to issue forfeiture bid bonds because the amount of the forfeiture doesn't necessarily relate to and is often much more than the actual damages incurred by the owner.

## 6 What is a performance bond?

A performance bond provides an obligee with a guarantee that, in the event of a contractor's default, the surety can be called upon to complete or cause to be completed the contract in accordance with its terms and conditions. Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.

If the bonded contractor fails to perform its work in accordance with the plans and specifications, the owner, having performed its contractual obligations, has a right to obtain completion of the contract from the surety.

## 7 What is a payment bond?

A payment bond ensures that certain subcontractors and suppliers will be paid for labor and materials incorporated into a construction project, if the bonded principal fails to pay them.

A subcontractor or supplier that has a right to make a claim against a payment bond is referred to as a "claimant."

Who a proper claimant is under a payment bond is typically restricted or limited by the language in the applicable statute, the contract, or the bond. Most payment bonds require a claimant that does not have a contract with the principal to give the principal or surety, or both, written notice of its claim within a specific period of time after furnishing the labor or materials for which the claim is made.

\A payment bond does not directly benefit an owner, but it provides indirect benefits by ensuring that unpaid downstream laborers and suppliers are unlikely to stop work during a project or, on private projects, file a lien, encumbering title to the project.

## 8 What is a warranty bond?

A warranty bond, sometimes called a maintenance bond, guarantees the owner that any workmanship and material defects found in the original construction will be repaired during the warranty period. They are typically used when an owner wants coverage for a warranty period beyond one year. A warranty period can be extended for an annual fee, but sureties are reluctant to provide warranty protection for more than two years after project completion. If the contractor is unable to resolve the warranty issue or is not in business during the specific warranty period, the warranty bond provides the owner with a remedy.

Sometimes owners will require long-term warranties, such as five or more years. A long-term warranty period imposed on a contractor presents considerable problems for a surety. Sureties are usually comfortable with warranty obligations of two years. Durations longer than two years increase substantially the uncertainty regarding underwriting projections about the contractor's future viability. Long-term warranty obligations also reduce competition from the standpoint of eliminating from the bidder/proposer pool all but the largest contractors, since only large contractors can shoulder the higher risks inherent in such contracts. This has the effect of reducing the bidder pool, which, in turn, translates into higher prices paid for the project by the owner. A long-term warranty requirement precludes many highly qualified bidders, lowering bid and price competition.

## 9 Are bonds required on public projects or private projects, or both?

Contract surety bonds are required in most instances by the federal government, state governments, and local governments; and private owners and general contractors often require surety bonds, recognizing their importance in project risk management.

Under the federal Miller Act and certain regulations, any federal construction contract valued at $150,000 or more requires a performance bond and a payment bond. Each state has a "Little Miller Act," similar to the federal Miller Act, which requires a performance bond and a payment bond for state contracts over a certain amount, called the bond threshold. Most municipalities require performance and payment bonds as well.

In the private sector, there is no mandate for the use of bonds on construction projects. Understanding the value of contract surety bonds, however, many private owners require contract surety bonds on their construction projects for the same reasons the government does. In the same manner, as a risk management tool, prime contractors will often elect to require that their subcontractors obtain performance and payment bonds. Sometimes construction lenders require bonds on projects as a condition for receiving financing.

## 10 Who are individual sureties and what do I need to know about them?

In the United States, almost all surety bonds are written by insurance companies regularly engaged in the business of acting as a surety. Surety companies typically are authorized and qualified to do business by the state insurance commissioner where they are domiciled and in the jurisdiction where the bond is issued. The state departments of insurance regulate surety companies, which must meet minimum capital requirements, file periodic financial reports in those jurisdictions where they are authorized to do business, and are subject to market conduct investigations, among other regulatory requirements and actions.

Almost all state insurance laws allow natural persons, not just companies, who wish to act as a surety on bid, performance, and payment bonds to obtain a license or certificate of authority from the state insurance department.

The history of individual surety use is replete with case law of individual surety deceptions, to the detriment of contractors, subcontractors, suppliers, and public and private owners. As noted in a report issued in 2013 by Maryland's Department of Insurance, *Final Report on the Analysis of the Practices of Corporate Sureties and Individual Sureties in Maryland,* individual sureties have engaged in misleading conduct, creating the illusion of a corporate form, misleading the public into believing that the same safeguards in place for corporate sureties exist for individual sureties.

The federal government does accept bonds from individual sureties—if they adhere to specific regulations governing their assets. Nonetheless, unlike the evaluation of corporate sureties by the Treasury Department, there is no central entity to evaluate individual sureties or their bonds.

## 11 What are the advantages to the owner and contractor in contract bonds v. bank letters of credit?

Project owners sometimes consider requiring bank letters of credit (LOCs) in lieu of bonds to provide financial protection in the event of contractor default. Owners should be aware of the important distinctions between surety bonds and LOCs. A bank LOC is a cash guarantee to the owner, who can call on the LOC on demand. The LOC is converted to a payment to the owner and an interest-bearing loan for the contractor that arranged it. While performance and payment bonds protect the owner from non-performance and protect certain subcontractors and suppliers from nonpayment should the contractor default, the performance of the contractor has no bearing on the bank's obligation to pay on the LOC.

Contract surety bonds and LOCs both provide financial protection to the owner; but bonds are superior to LOCs in their effect on borrowing capacity, duration, coverage, cost, contractor qualification, and claims. Bonds do not diminish the contractor's borrowing capacity; bank LOCs do diminish a contractor's line of credit, which could adversely affect the contractor's cash flow.

Surety bonds remain in place for the duration of the contact, plus a warranty period, subject to the terms and condition of the bond, the contract documents, and governing statutes. An LOC is usually date-specific, often for one year. They may contain "evergreen" clauses for automatic renewal, with associated fees.

A performance bond is 100% of the contract amount for project completion; a payment bond is 100% of the contract amount to protect certain subcontractors and material suppliers. An LOC can be obtained for a percentage of the contract amount, but 5%-10% of the contract amount is typical. An LOC provides no protection that subcontractors and suppliers will be paid in the event of contractor default. They may file liens on private projects.

The cost for both the performance and payment bonds is generally 0.5%-3% of the contract price and is included in the contractor's bid price. The cost of an LOC is generally 1% annually of the LOC amount. The cost of an LOC is included in the contractor's bid price.

A surety company analyzes a contractor's operations, financial resources, experience, organization, workload, management, and profitability to determine that the contractor is capable of performing the contract, in order to avoid default. A banker examines the quality and liquidity of the contractor's collateral in the event there is a demand on the LOC. Other than determining if the contractor can reimburse the bank if demand is made on the LOC, there is no further prequalification performed by the banker.

If the owner declares a contractor in default and the surety, after its independent investigation, determines that the contractor defaulted, the surety will select a completion option for performance and pay the rightful claims of subcontractors and suppliers, up to the penal sum of the 100% performance and payment bonds. With LOCs, the bank will pay an LOC on demand if made prior to the expiration date; but the owner must administer completion of the contract and determine the validity of claims and the amounts of payment to the subcontractors and suppliers.

## 12 What are the advantages to the owner in using bonds rather than subcontractor default insurance?

Subcontractor default insurance (SDI) is a two-party, catastrophic insurance policy that provides general contractors with insurance coverage for direct and indirect costs of trade contractor default. Some general contractors, generally those with subcontract volume exceeding $50 million, that are eligible for SDI coverage see it as an alternative to the purchase of subcontract bonds. Unlike subcontract bonds, SDI is traditional insurance that presumes some level of losses; and general contractors that purchase SDI must bear a significant level of self-insurance for such risks through high deductibles and co-payments. Little or no losses in the SDI program might translate into higher margins for the insured general contractor. It is critical to understand, however, that SDI, as a product, is very different from surety bonds and is never a replacement for statutory federal, state or local bond requirements.

SDI can put a much bigger burden on the prime contractor than subcontractor bonds. With subcontract bonds, the surety performs the prequalification of potential subcontractors; in the event of default, provides complete risk transfer from the general contractor to the surety, with first-dollar coverage; manages the subcontractor default; and provides payment protection for lower-tier subcontractors and suppliers. With SDI, the general contractor performs the prequalification of the potential subcontractors; in the event of default, retains a portion of the risk through high deductibles and co-payments; manages the subcontractor default, including completion of the subcontractor's work; and there is no payment protection for lower-tier subcontractors and suppliers.

Accordingly, significant losses can jeopardize the operations of the insured general contractor, which will bear the expenses of the deductibles and co-payments and the burden of administering claims. The benefits of SDI flow only to insured general contractors, while the benefits of subcontract bonds flow not only to general contractors but also to subcontractors and suppliers and, indirectly, to owners.

The following chart is a broad overview of the features and purposes of subcontract bonds and SDI, with key aspects of each:

| ISSUE | PERFORMANCE AND PAYMENT BONDS | SUBCONTRACTOR DEFAULT INSURANCE |
|---|---|---|
| **Prequalification Process** | Conducted by the surety, a knowledgeable third party (extensive and ongoing) | Conducted by the general contractor, not a third party |
| **Structure** | 3-party agreement (general contractor, subcontractor, and surety) | 2-party agreement (general contractor and insurer) |
| **Regulation** | Sureties are regulated by state insurance departments | Surplus lines basis |
| **Risk** | Complete risk transfer from general contractor to surety, with first-dollar coverage of 100% performance bond and 100% payment bond | General contractor retains a portion of risk through high deductibles and co-payments |
| **Payment Protection for Subcontractors and Suppliers** | 100% payment bond, with first-dollar payment benefit for subcontractors and suppliers | No payment benefit for subcontractors and suppliers |
| **Subcontractor Default Management** | If subcontractor defaults, surety completes, arranges for, or pays for subcontract completion up to bond amount | General contractor must manage subcontractor default, including completion of subcontractor's work |
| **Payment of Losses** | Surety pays losses after independent investigation | General contractor must pay first losses and then submit documentation to recover from the insurer |
| **Legal Precedents** | Extensive history of case law/legal precedents | Little or no case law/legal precedents |
| **Confidentiality of Subcontractor Information** | Subcontractor has confidential and on-going relationship with surety | Subcontractors are uncomfortable providing sensitive financial data to the general contractor (who might be their competitor bidding on the next project) |
| **Premium** | Cost calculated based on contract amount, depending on size and type of project | Cost is calculated on general contractor's program costs and the deductibles and co-payments selected |
| **Cancellation** | The bonds cannot be cancelled | SDI can be cancelled by the insurer |
| **Indemnity** | Subcontractor is incented to perform by its indemnification obligation to the surety | SDI provides no such incentive other than for the subcontractor not to be sued by the insurer |
| **Limits** | Combined performance and payment bonds are equal to 200% of the contract amount | Policy subject to aggregate limit and per loss limit; sublimits also may apply, such as three or four times the subcontract value |
| **Unseen Assistance** | Sureties, with the expectation of no losses, provide assistance to bonded subcontractors through financing, engineering, and operational services | Insurers, with an expectation of losses, provide no assistance to subcontractors |

## 13 What is the cost of the bonds?

The cost of a bond is based on rates filed by insurance companies with the state insurance department and is based on the contract amount. The cost of a bond can vary, from less than 0.5% to as much as 3% of the contract price. For a small and emerging contractor with minimal experience, a contractor can expect to pay 2-3% of the contract price. There are adjustments to the bond cost based on the final contract price. If the price increases, there's an increase in premium; and if the price decreases, the cost is reduced as well. A contractor should always include the cost of its bond in its change orders, no matter how small. Several small change orders over time can turn into a large increase in the contract, which will result in an increase in cost.

## 14 When are bond premiums typically paid?

Bonds must be paid when they are executed. Bonds are non-cancelable.

## 15 How extensive is the surety's prequalification process?

Contractor prequalification, as performed by surety underwriters, involves a thorough and continuing process of reviewing and evaluating balance sheets, work-in-progress schedules, and financial statements. Surety underwriters will also evaluate factors such as the risk under the specific contract for which the contractor seeks a bond, the contractor's entire work portfolio, past performance, experience, operational efficiency, managerial skills, business plan, and reputation for integrity.

Obtaining bonds is more like obtaining bank credit than purchasing insurance. Different sureties will stress varying factors during the underwriting process, but almost all will consider the following factors:

- ➔ Financial capacity
- ➔ Net worth
- ➔ Cash flow
- ➔ Assets
- ➔ Credit score
- ➔ Work in progress
- ➔ Work history, including expertise and experience
- ➔ Banking relationship
- ➔ Nature of project to be bonded
- ➔ Character of the contractor

Surety underwriting is an ongoing evaluation process, which includes the principal's entire work program.

## 16 What is a general agreement of indemnity?

A general agreement of indemnity, or GIA, is a contract between a surety company and a contractor. The GIA is a powerful legal document that obligates the contractor and other indemnitors to protect the surety company from any loss or expense that the surety has as a result of having issued bonds on behalf of the bond principal. In this manner, the contractor and other indemnitors have "skin in the game" for each contract, as the contractor's GIA incents the contractor from walking away from a bonded contract. Under a GIA, if the contractor fails to fulfill its bonded obligation under a contract and the surety suffers any loss, the indemnitors are legally bound to indemnify, or pay back, the surety for its losses.

A fundamental concept of suretyship is that the surety will not sustain a loss. The surety expects to be indemnified (that is, paid back) and reimbursed for any payments or losses by the principal and indemnitors under the indemnity agreement. Therefore, the GIA is needed before the surety issues any bonds on behalf of the principal. The GIA will apply to all bonds issued by the surety for the principal.

The GIA is an extremely powerful document that encourages contractors to honor their bonded obligations.

## 17 Who typically signs the general agreement of indemnity?

If a surety company decides that a contractor should be extended surety credit, the surety company will require that the contractor, as well as others, sign a contract, the GIA, before it will issue bonds on behalf of the contractor.

A surety company that issues bonds on behalf of a contractor almost always requires that the principal, the individuals who own and/or control the company, their spouses, and often affiliated companies sign the GIA. Both the principal and the third-party indemnitors can be individuals, small business entities and partnerships, and large international corporations.

## 18 What determines a contractor's bonding capacity?

Bonding, like bank credit, is dependent on strong financials and adequate liquidity for a contractor to undertake the backlog of construction projects. Contractors need to have sufficient cash flow in terms of cash and working capital to be able to upfront the costs for insurance, bonding, labor, materials, and overhead for 60 to 90 days until they receive the first payment certification from the owner. Multiple projects require organization, cash flow, and plenty of managerial experience.

Under similar circumstances, bonding capacity will always favor those contractors that have superb financial information, which can be provided to surety companies on a transparent and timely basis, showing organization, commitment, and security that problems arising during the normal and customary business environment will be identified and dealt with immediately. Other important factors include a successful track record for the same types of projects, experienced personnel and subcontractors, on-time accounts receivable collection (that is, no collection problems), and sufficient bank lines of credit to assist in case of a temporary situation where the contractor may not collect certifications on time.

Although bonding is as much an art as a science, the better organized a contractor is in terms of project construction and administration matters, the higher the chances are that bonding capacity will match or exceed the contractor's expectations.

## 19 Why are sureties uncomfortable with long-term warranties? Do extended warranties cost extra or affect the availability of bonds?

Yes, extended warranties do cost extra; and, yes, they do affect the availability of bonds. A lengthy warranty period, such as one of 5 or more years, imposed on a contractor or subcontractor poses considerable problems from a surety underwriting perspective. Sureties are usually comfortable in covering a warranty obligation of up to two years. "Certainty" is a word that sureties like. Durations longer than two or three years increase substantially the uncertainty regarding underwriting projections about the contractor's future viability. In other words, sureties cannot gauge the soundness and financial wherewithal of a particular construction company for periods extending too far into the future.

Long-term warranty obligations also reduce competition from the standpoint of eliminating from the bidder/proposer pool all but the largest contractors, since only large contractors can shoulder the higher risks inherent in such contracts. This has the effect of reducing the bidder pool, which, in turn, can translate into higher prices paid for the project by the owner. Such longer warranty requirements effectively preclude many highly qualified contractors, significantly lowering bid and price competition on such projects.

Construction projects typically involve a number of different warranties, both of workmanship and of items incorporated into the work, such as roofing systems and equipment. Those warranties provided by a contractor, as opposed to pass-through warranties from the manufacturer to the owner, need to be of limited duration.

## 20 If the general (or prime) contractor requires its subcontractors to be bonded, is the owner protected, too?

When a general contractor requires bonds from its subcontractor, the subcontractor's performance bond provides protection to the general contractor for the subcontractor's failure to perform the bonded subcontract. The subcontract performance bond provides no direct protection to the owner; however, the owner indirectly benefits by having the general contractor address its downstream risks through subcontract bonds. Subcontract bonds do not address the performance risks of the general contractor to the owner; only the general contractor's performance bond addresses that risk. Without a performance bond from the general contractor, the owner has no direct protection if the general contractor defaults under the prime contract.

## 21 Are standardized construction contracts used in the construction industry?

Yes. There are a number of standard form contracts that are published by various construction industry stakeholders: America Institute of Architects, ConsensusDOCS, Design-Build Institute of America, and Engineers Joint Contracts Document Committee. These standard form contracts are usually modified by the parties before signing. There are also customized or manuscripted contracts, to address project-specific requirements.

Most standardized construction contracts contain similar language for certain key clauses that is mutually fair to owners and contractors, but even changing a few words can significantly change a contractor's risk profile. If the contract terms and conditions are onerous for the contractor, the owner significantly reduces the bidder/proposer pool and increases the contract amount. Sureties do not relish issuing bonds for contracts that contain terms and conditions onerous to the contractor.

Sometimes, in trying to protect themselves, owners will produce contracts with onerous terms and conditions, exponentially increasing the contractor's—and the surety's--risks. Such a situation decreases bidder interest and competition, increases cost contingencies, and puts contractors and sureties in unacceptable risk positions.

## 22 What is a dual obligee bond?

A dual obligee bond, sometimes called a co-obligee bond, names an additional oblige to the bond. An additional obligee might be named in the bond itself or will be added in a dual obligee rider, to extend a surety's obligation under the bond to that interested third party. The additional obligee is usually a construction lender, although other entities having some interest in the completion of the project, such as title insurers, can also be dual obligees.

The addition of a dual obligee on a bond should not change the extent of the surety's liability under the bond, if the bond contains a "savings clause," stating that the surety's liability should be expressly limited to "one penal sum." An example of a savings clause in a dual obligee rider is the following:

1. The Principal and the Surety shall not be liable under this bond to the Obligees, or either of them, unless said Obligees, or either of them shall make payments to the Principal (or to Surety if it arranges for performance of the Contract) in accordance with the terms of said contract as to payment and shall perform all the other obligations to be performed under said contract at the time and in the manner therein set forth.
2. Provided, however, that the attached bond as changed by this Rider shall be subject to all its agreements, terms and conditions and limitation except as herein expressly modified, and that the liability under the attached bond as changed by this Rider shall not be cumulative and shall be limited in the aggregate to the penalty of the said bond.

The purpose of the savings clause is to place both the primary obligee and the additional obligee in the same position and subject both to the same defenses and to ensure that the surety's aggregate liability is limited to the penal sum of the bond. A savings clause will relieve a surety from liability under the bond, to either and both of the obligees, if either of the obligees fails to make payments strictly in accordance with the terms of the bonded contract or fails to perform all other obligations under the bonded contract. A number of courts have recognized that a "savings clause" in a dual obligee bond or rider is a condition precedent to the assertion of a claim against a surety by an obligee owner or a dual obligee lender.

## 23 What are the obligations, if any, for an owner to provide copies of payment bonds to potential claimants?

Private owners generally are not required to provide copies of payment bonds to potential claimants, although some standardized contract agreements include the right of subcontractors to request copies. Most public owners, however, have obligations to provide such bonds upon request. The Federal Acquisition Regulations (FAR) provide authority for subcontractors and suppliers and prospective subcontractors and suppliers on federal projects to request and obtain copies of payment bonds from the contracting officer. FAR 28.106.6(d) provides as follows:

> Upon the written or oral request of a subcontractor/supplier, or prospective subcontractor /supplier, under a contract with respect to which a payment bond has been furnished pursuant to the [Miller Act], the contracting officer shall promptly provide to the requester, either orally or in writing, as appropriate, any of the following:
>
> 1. Name and address of the surety or sureties on the payment bond.
> 2. Penal amount of the payment bond.
> 3. Copy of the payment bond. The contracting officer may impose reasonable fees to cover the cost of copying and providing a copy of the payment bond.

## 24 Is it important for an owner to communicate early with the surety in addressing potential performance defaults?

Yes. A surety's ability to favorably impact a default is directly related to the owner's keeping the surety informed of potential problems on the project. An owner's early communication with the surety vastly improves the surety claims process. Many contractors and subcontractors, however, are excellent problem solvers; so overzealous notification of potential problems can lead to complications.

Some performance bonds require a meeting among the obligee, principal, and surety prior to any declaration of default. Even if the bond does not require it, such a meeting is almost always useful. If there are such serious problems on the job that the obligee is considering a termination for default, the surety wants to know about it. Surety claims professionals are experienced in dealing with troubled projects, often leading to avoidance of a default termination.

The surety has the ability to advance funds to finance contract completion by the principal. The surety in this circumstance has an interest is making sure that contract funds are used on the bonded project.

## 25 Can sureties help avoid performance defaults?

Yes. There are hundreds/thousands of situations where sureties have mitigated performance problems. And that is why it is critically important that an owner communicate early with the surety about any potential performance problems of its bonded principal. If the surety is unaware of problems, it cannot begin to address them.

A surety that is made aware of problems by its bonded principal, claimants, or the owner, or all three, is potentially in a good positon to help mitigate issues before the owner takes drastic measures. To that end, sureties have the ability to offer their principals assistance; accounting and technical assistance are typical examples. One unseen benefit is where a surety takes control of contract funds and provides additional capital to a struggling contractor to avoid a default. This may happen without the obligee knowing that a problem exists and happens more often than many obligees realize.

## 26 What can I expect in a performance default situation?

A performance bond provides assurance that an obligee will be protected if the principal fails to perform a bonded contract. It is a "safety net." If the contractor breaches the contract and the owner declares the contractor in default, the surety has an obligation to the owner, under the performance bond, to honor the obligation. The surety has both a right and a duty to promptly conduct an independent investigation of the owner's allegation that the contractor is in default under the contract and the contractor's position that it is not in default.

The process of making a bond claim is governed by the entire body of construction law and precedents associated with the construction industry. The surety must respond to an owner upon notice of default without jeopardizing the rights and defenses of the contractor as it conducts its investigation. A surety is obligated to respond to a claim after investigating the facts associated with the alleged default of the contractor.

## 27 Why is formal termination needed before a surety will assume the responsibility for performance of a contract?

Two contractors cannot perform the same work for an owner and a surety at the same time. Although sureties will insist that they cannot assume responsibility for performance unless the contractor is terminated by the owner, that does not mean they cannot and should not investigate the problems and consider alternatives to improve performance prior to termination.

If the obligee decides to terminate the bonded contract, the surety and the obligee generally have a number of options. Some bond forms describe the options, and some forms are silent. Whether or not the bond sets forth the options, it always makes sense to explore all possible options for the resolution of disputes and the completion of bonded work.

## 28 Why does the surety have different options in the event of a default?

If, after it has conducted its independent investigation, the surety decides to perform, it may have a variety of performance options that it must evaluate. Each has its advantages and disadvantages. It is not in the obligee's best interests to restrict the surety's options.

The obligee that insists that the default be remedied in only one way may miss opportunities for saving time, money, and frustration.

## 29 What are typical options available to the surety to remedy a performance default?

**Tender Option**

The surety and the obligee can agree on a replacement contractor to complete the bonded work. This is referred to as the surety's "tender option," because the surety "tenders" a new contractor to the obligee. If the replacement contractor's price exceeds the balance remaining in the bonded contract, the surety will fund the excess either by paying the replacement contractor as the work proceeds or by paying the obligee the amount of the overrun in return for a release. Typically, the obligee and the surety will insist that the replacement contractor provide new bonds from its own surety to guarantee its performance of the completion work.

**Takeover Option**

Another option is for the surety to assume or "take over" responsibility for completing the remaining work. The surety would then hire construction professionals to manage and perform the completion.

If the takeover option is used, the surety and the obligee often will enter into a "Takeover Agreement" setting forth their respective rights and obligations in connection with completion of the work.

**Allow Obligee to Complete**

Another option is for the surety to elect not to be involved in the completion work. In this scenario, the surety remains exposed to the owner for the costs to complete in excess of the remaining contract balance up to the penal sum of the bond.

Because this option leaves the surety with little or no control over the manner in which the work will be completed, it is not one often exercised. The most common situation in which the surety elects this option is if the job is close to completion and the obligee's plan for finishing the work is reasonable.

**Denial of Claim**

If the surety, after its investigation, concludes that it has no liability under its bond, the surety will deny the claim.

**Other Options**

Other options might include up-front cash settlements, continued performance by the original contractor, and various combinations of all the possible options.

## 30 How do I know if a bond is valid and has been authorized by the surety?

There are, unfortunately, unscrupulous persons and entities in the marketplace that prey on owners, contractors, and subcontractors by issuing fraudulent surety bonds. Therefore, it is critical that you confirm that the surety is licensed in the jurisdiction of the project and that the bond has been authorized by that surety. You can perform this task by undertaking the two-step process set forth below:

1. **Check the authority of the surety to issue the surety bond:**
   - Contact the state insurance department to determine if the surety is admitted in the jurisdiction of the project. Generally, sureties must have a certificate of authority from the insurance commissioner in each state in which they conduct business. The National Association of Insurance Commissioners provides a map with links to all state insurance departments, at **http://www.naic.org/state_web_map.htm.** Some states list admitted sureties on the insurance department website, but a quick call to the department will ensure the most current and complete information.
   - Consult the U.S. Department of the Treasury Listing of Approved Sureties, Department Circular 570. To provide surety bonds on federal construction projects, a corporate surety must possess a certificate of authority from the U.S. Treasury Department. A listing of certified surety companies approved to provide bonds on federal contracts, known as Circular 570 (or the T-List), is posted by the Financial Management Service, Surety Bond Branch of the Department of Treasury, at **https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm**
2. **Verify that the surety actually authorized the issuance of the surety bond:**
   - Contact the surety directly to receive verification that the surety bond has been duly authorized. All sureties listed in Circular 570 identify a specific contact phone number. In addition, the Surety & Fidelity Association of America administers a program in which surety companies voluntarily agree to receive inquiries for the purpose of verifying the authenticity of surety bonds, in the SFAA Bond Obligee Guide, at **http://www.surety.org/page/User_Information.**

Nothing should replace your own exercise of due diligence regarding the authenticity of surety bonds. The internet is replete with stories of owners, contractors, and subcontractors that have been subject to fraudulent bonds.

## 31 What do I need to know about an attorney-in-fact and powers of attorney?

Most surety companies issue surety bonds through surety bond producers (independent agents). When a contractor or subcontractor needs a bond, the contractor or subcontractor's first step is to contact a surety bond producer. Producers generally have powers of attorney from a surety company (or more than one), which means that the producer can sign bonds on behalf of the surety company for contracts that fall within the ranges established by the surety company. The attorney-in-fact is the person named in a power of attorney.

## 32 Why can't procuring agencies require resident agent signatures or resident agent countersignatures on their bonds?

No owner can soley require resident agent signatures or resident agent countersignatures on its bonds for the simple reason that it is no longer legally permissible to do so in any state in and jurisdiction of the United States (with the exception of Guam, where it has not been challenged in court). The resident agent signature and countersignature requirements have been held as unconstitutional by federal courts throughout the United States and/or have been eliminated through acts of state legislatures, because such requirements impermissibly favor licensed resident agents over licensed non-resident agents.

Please note that, while the resident agent countersignature requirement is unconstitutional, it is wholly permissible for a countersignature requirement to be in place. This would mean that a bond could be countersigned by a licensed agent, either a licensed resident agent or a licensed non-resident agent.

Not every design professional or other consultant for owners is aware that "resident only" requirements violate the law. Owners should be attuned to this impropriety and remove any such requirements before issuing requests for bids or proposals.

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SuretyLearn

For more information and resources, visit www.suretylearn.org