Understand Your Bond Before You Sign

Introduction

Before signing a surety bond, a contractor (including subcontractors) needs to understand the meaning of the surety bond's terms. A surety bond is a three-party agreement in which one party secures a second party's performance to a third party. Contract surety bonds secure the performance of construction contracts. A performance bond secures, for the benefit of the project owner, the contractor's performance of the contract. The payment bond secures, for the benefit of certain subcontractors and suppliers, the contractor's obligation to pay those subcontractors and suppliers. If there is a default in the underlying obligation (the construction contract), the surety steps in to remedy that default.

You should be aware that a performance bond usually incorporates the terms and conditions of the underlying construction contract. Therefore, an important part of the surety underwriting process is to know and understand the terms of the construction contract.

In addition, a performance bond and a payment bond have terms and conditions that are included in the form itself. Along with the terms of the construction contract, the terms included in the bond form determine the risk undertaken by the surety and the contractor. Remember: a contractor signs the bond, too. Furthermore, the surety has a right to be held harmless by the contractor for any losses incurred under a bond through indemnification. Because the contractor bears the ultimate financial risk, it is critical for contractors to sign only contracts with terms they understand and risks they are willing to assume.

The contractor must be aware of onerous terms that increase the risk for the surety and the contractor beyond reasonable levels. The contractor should especially be aware of the bond terms because the bond form is given by the project owner. There is generally very little room for negotiation of the bond form terms. Therefore, the contractor and the surety must be fully aware of the risks.

It is in no one's best interest for the form to include one-sided language and terms that shift risk inappropriately. This sets a "win-lose" environment for the parties' relationship from the beginning, which may lead to adversarial relations throughout the life of the project. If you sign an onerous contract or bond, you may be assuming risks that eliminate profits on the project or, if severe losses occur, cause the insolvency of your construction business.

Anatomy of a Bond Form

A bond form has three main parts. The first is the "binding paragraph." It names the three parties to the bond and states that the surety and the principal (the contractor) are jointly and severally bound to the obligee (the project owner). This paragraph also states a financial limit to the obligation owed by the surety to the project owner. This limit is called the "penal sum."

The second part of a bond form is usually quite short. Much of the substance of the obligation is included in the construction contract. Therefore, the construction contract is included in the bond form by reference. For example:

> The conditions of this obligation are such that, whereas the Principal entered into a certain contract, hereto attached, and made a part hereof, with the State of Texas, acting by and through the Board of Regents of The University of Texas System for and on behalf of ___________________________________, dated _________________, _________, for ___________________________ (Project No. ________).

The next paragraph includes the condition and coverage of the bond. It usually states that the condition of the obligation under the bond is that the contractor will perform the contract. If the contractor performs the contract, then the bond is "null and void." If the contractor does not perform, the bond remains "in full force and effect;" and the surety's obligations are triggered. For example:

> NOW, THEREFORE, the conditions of this obligation are such that, if the Principal shall faithfully perform the said Contract in accordance with the Plans and Specifications and Contract Documents, and shall fully indemnify and save harmless the State of Texas from all cost and damage which the State of Texas may suffer by reason of Principal's default or failure so to do and shall fully reimburse and repay the State of Texas all outlay and expense which the State of Texas may incur in making good any such default, then this obligation shall be null and void, otherwise it shall remain in full force and effect.

A bond form needs only these three parts: (1) a binding paragraph; (2) a reference to or description of the underlying obligation; and (3) the bond condition. However, the need for greater detail or expansion of the scope of the surety's obligations has caused the addition of other provisions. These provisions address such issues as the claims process after the contractor is in default, waiver of certain rights of the surety, and the duration of the surety's obligation. These additional provisions can be onerous and can increase both the surety's and the contractor's risk.

Problematic Bond Language

Bonds can contain language that significantly increases the risk to the surety and the contractor. Below are examples of some common modifications to bond form language that are problematic from the surety's—and contractor's--perspective.

- *Language that makes it easier to trigger the surety's liability*

A bond obligee will sometimes insert language that, in effect, acts as a "hair trigger" for the surety's liability. An example is language inserted in a performance bond that "any breach," regardless of the significance of the breach, will be grounds for the obligee to call on the surety. The customary trigger for the surety's bond obligation is the default of the bond principal. A default requires a substantial contract breach, which justifies the termination of the construction contract. Many contract breaches are insignificant. By saying "any" contract breach, the project owner might argue that the bond permits the obligee to make demand upon the surety for even insignificant deviations from the contract requirements.

- *Language that increases the surety's monetary liability beyond the original penal sum of the bond*

Obligees sometimes place language in performance bonds that would automatically increase the bond penal sum to account for the amount of each additive change order. In most situations, especially when the performance bond has been set in the amount of the original contract price, such a modification is not necessary because the performance bond still covers the obligation to complete the work of change orders.

Often coupled with the automatic increase in the bond penal sum is a requirement that the surety waive notice of or consent to such bond penal sum increases. By agreeing to language that waives the surety's consent to an increase in the penal sum, the surety would not be entitled to notice of such increase and might not know its ultimate liability. Without knowing it, the surety could assume a bond limit of liability that exceeds the maximum exposures set in its reinsurance treaty or could exceed the maximum bond a surety is permitted to write under state or a federal regulation.

Some obligees try to convert the performance bond into a "forfeiture" bond where the surety must pay the full amount of the bond penal sum in the event of a contractor default, regardless of the actual amount of the losses. This is not a good situation for either the surety or the contractor, who must indemnify the surety for its losses.

- *Language that significantly lengthens the time the surety remains liable*

The surety's obligation under the bond is limited to the set term stated in the bond. For example, a commonly used performance bond form, AIA Document A312, states that the obligee must bring suit on the bond within two years after contractor default, of when the contractor ceased working or of when the surety refused to perform its bond obligations, whichever occurs first. In addition, a statute may set a minimum period of time under which the surety remains liable on the bond. In either event, such limitation periods usually cover a few years at the most. This is because it is difficult for the surety to underwrite obligations that extend for longer periods of time. Surety underwriters cannot predict with any degree of confidence the financial strength of a company over periods extending too far into the future. When obligees extend the time to bring a claim, this creates increased uncertainty and risk for the surety and the contractor.

In addition to increasing the time to bring suit against the surety, obligees may expand the duration of the bond obligation. Some obligees view the surety bond as an instrument to secure a long-term guarantee. Such modifications may take various forms, such as a clear alteration of the time period stated in the bond or, in a more subtle form, such as incorporation into bond coverage a time period running to the expiration of all warranties relating to the work. This example might extend the bond obligation to cover such long-term warranties as roofing warranties, which might run twenty or more years.

Conclusion

Construction business owners should carefully review all bond forms as an important part of their risk management strategies. By doing so, construction business owners will be able to better avoid problematic bond language that seeks to shift risks inappropriately or that imposes obligations that they should not assume and that their sureties will be reluctant or unable to underwrite. Remember, if the surety suffers any loss as a result of having issued bonds on behalf of your company, the surety will look to your company and the other indemnitors to make it whole.