

Risk and Responsibility: Understanding Surety Bonding

A Study Guide

What Are Surety Bonds?

Contract surety bonds provide assurance to the project owner that a contractor is capable of completing a project according to contract specifications.

Suretyship is a loss-avoidance mechanism to prequalify contracting firms based on their credit strength, experience, and capability to successfully complete contracts. The economic risk of contractor default stays with the bonded contractor, who must sign an indemnity agreement holding the surety harmless. When it issues a surety bond, the surety company has prequalified the contractor and offers assurance to a project owner that the contractor is capable of performing the contract according to its terms and conditions. Furthermore, the surety company guarantees that the contractor will pay certain laborers, subcontractors, and suppliers associated with the project.

How Does a Surety Bond Work?

Contract surety bonds are three-party agreements whereby one party (the surety company) guarantees another party (the owner) that a third party (the contractor) will perform the contract. The owner specifies the bond requirement in the contract documents. It is the contractor's responsibility to secure the bonds.

Because of the intricacy of the bonding process, and the fact that each surety company has its own unique underwriting standards and practices, contractors turn to surety bond producers to secure the surety bond on their behalf. The contractor includes the cost of the bond premium in his/her bid price. The surety company typically charges only for the final bond(s) when the contractor is awarded the contract.

Bonds are required on most public work projects. Most public works contracts are awarded under a competitive, sealed, open competition bidding system where the work is awarded to the lowest responsive bidder.

To protect tax-payer dollars from irresponsible bidders and incapable contractors, Congress passed the Heard Act in 1894, which required contractors to obtain surety bonds on public work. The Heard Act was later replaced by the Miller Act of 1935, which mandates performance and payment bonds on all federal public work contracts in excess of \$100,000. Most state and local governments have adopted similar legislation (often referred to as "Little Miller Acts"). The requirements stipulated by "Little Miller Acts" vary by state.

Types of Contract Surety Bonds

The bid bond provides financial assurance that the contractor is capable of performing the contract at the price bid, and will comply with the conditions of the bid, including entering into a final contract if the successful bidder. It also assures the owner that the surety company will issue the requisite payment and performance bonds. If the contractor is awarded the contract but fails to enter into the agreement, the surety may be required to pay the difference between the awarded bid and the next lowest bid or pay the bond penalty.

The performance bond protects the owner from financial loss should the contractor fail to meet the terms and conditions of the contract. If the contractor defaults, the surety will respond in accordance with the terms of the bond.

A payment bond guarantees that the contractor will pay certain laborers, materials suppliers, and subcontractors. Payment bonds issued by themselves only guarantee that the project will remain lien free for the obligations assumed by the principal. If the contractor fails to pay amounts properly due, the surety will make the payments up to the penal amount of the bond (stipulated in the contract). Generally, payment bonds are supplied at no additional cost when purchased in conjunction with a performance bond.

Benefits of a Bond

- Greater pool of qualified contractors bidding for jobs, resulting in greater likelihood of timely project completion and less likelihood of contractor failure;
- Payment protection for subcontractors, suppliers, and laborers (Subcontractors and suppliers may submit more competitive prices if they know they're protected by a payment bond);
- Technical, management, and/or financial assistance for the contractor to keep project on schedule;
- No liens from unpaid subs and suppliers covered by the payment bond, which will smooth transition from construction to permanent financing; and
- Guarantees correction of defects as a result of faulty material or workmanship for at least one year.

Contractors Must *Qualify* for Surety Bonds

The process of obtaining bonds is more like obtaining bank credit than purchasing other types of insurance. When obtaining bank credit, the financial institution will only provide the loan if it determines the party is capable of repaying it in full with interest. With traditional insurance, premiums are paid based upon deductibles and expected losses. Surety companies, however, do not expect a loss. Sureties should not bond a contractor that does not meet their prequalification standards. The primary service of the surety is prequalification. Therefore, the surety bond premium is primarily a fee for service and granting of surety credit.

A surety offers financial backing for the contractor. It does not lend a contractor money, but rather commits its financial resources to back the commitment of the contractor. This enables the contractor to acquire a contract with the owner.

The Prequalification Process

The surety company's prequalification process (also referred to as underwriting) carefully analyzes the contractor's entire business operation, because the surety is backing the promise of that contractor to perform the contract. The surety company evaluates the contractor's capacity to perform this particular contract as well as other contracts already written, determines his/her financial strength, reviews his/her character, and may ask for personal or corporate indemnity. The surety bond producer assists the contractor with prequalification, as described in "Surety Bond Producer" on page 8.

Capacity to Perform-typically includes analysis of:

- Resumes of the contractor and key personnel;
- Contractor's track record of successfully completed work;
- Adequacy of the contractor's equipment and tools required to perform the contract;
- Rationale for why the contractor is undertaking the project;
- Continuity plan that illustrates how the company will continue performing its obligations in the event of the demise or departure of key personnel; and
- Contractor's future plans, short and long-term goals, objectives, and growth strategies.

Financial Strength-typically includes analysis of:

- Detailed financial statements for the past 3-5 years. Accounting methods should comply with Generally Accepted Accounting Principles (GAAP). Financial statements should include: Balance Sheet, Statement of Earnings, Statement of Changes in Owner's Equity, Statement of Cash Flow, Notes to Financial Statements, and Contract Schedules. The surety may ask for interim financial statements. Requirements for interim statements vary, but a six-month statement usually is the minimum.
- Contract schedules that typically include a summary of completed contracts and contracts in progress. Sureties also will require a schedule of work in progress (usually quarterly). This schedule should list each job by name and indicate the total contract price including: change orders, amount billed to date, cost incurred to date, revised estimate of the cost to complete, estimated gross profit, and the anticipated completion date;
- Cost records that account for the financial status of the contractor's jobs;
- Credit reports demonstrating how the contractor handles payment of debts; and
- A bank line of credit showing unsecured credit that can be used as short-term working capital.

Character-Surety companies may review trade references from owners, architects, subcontractors, general contractors, material suppliers, etc., with whom the firm has worked to get a sense of the contractor's reputation for fair, businesslike dealings.

Indemnity Agreement-Surety companies may require the personal indemnity of the owners, their spouses, or major stockholder(s) of the construction firm to assure that they are going to put forth their best efforts to meet contract obligations. In some cases, personal assets can increase surety credit available to the construction firm. For a proper evaluation of what loss paying power the personal indemnity does provide, the surety may request the contractor to provide personal financial statements.

Contractor Default

Although the prequalification process greatly reduces the likelihood of contractor default, a host of problems can befall a construction project, which may cause the contractor to fail. Contractor failure may be brought on by any of these events or a combination thereof:

Accounting & Financial Management Problems

- Inadequate cost and project management systems
- Estimating or procurement problems
- Poor bidding
- Cost Overruns
- Lack of adequate insurance
- Improper accounting practices (not adhering to the American Institute of Certified Public Accountants *Audit Guide for Construction Contractors*)

Changes in Ownership and/or Key Personnel

- Leadership and focus of company changes (contractor retires, dies, sells company, etc.)
- No ownership or management transition plan exists to ensure continuity in the event of death or disability.
- Key staff leave company. Inadequate time to train new staff and bring them up to speed on company policy and operations, thus leaving projects ill-managed.

Changes in Strategic Direction

- Change in type of work performed by contractor
- Changes in the location of the work performed
- Significant increases in the size of individual projects
- Rapid expansion

Uncontrollable Factors

- Economic down-turn and high inflation
- Weather delays
- Poor site conditions and/or building plans
- Labor difficulties (lack of skilled labor)
- Failure of subcontractors or suppliers
- Material and equipment shortages
- Lack of or delay in payments by project owner
- Unreasonable project owner

Although these events are not always foreseeable at the time a bond is issued, there are warning signs that a contractor is in trouble.

Ineffective Financial Management System

- Inability to forecast cash flow
- Receivables turning over too slowly
- Vendors demanding cash on delivery for supplies and materials
- Past due bills

Bank Lines of Credit Constantly Borrowed to their Limits

- All credit fully secured
- Credit lines not being renewed

Poor Estimating and/or Job Cost Reporting

- Erratic bid spreads
- Profit margins are thin or not realized
- Profit fade

Poor Project Management

- Inadequate supervision
- Inability to administer and collect change orders
- Project(s) not completed on time

- One or more contracts with a claim
- Company frequently involved in litigation

No Comprehensive Business Plan

- Contingency plans not developed
- Company has no "road map," goals, or objectives

Continual Downward Spiral

- Revenue and margins decrease over time
- Continued operating losses
- Loss or reduction of bonding capacity

Communication Problems

- Disputes between contractor and owner
- Poor communication between field and management

Loss of Loyal Customers

- Decreasing reputation in the industry

Claims Handling

When a contractor gets into trouble, the surety may look at several options to avoid further deterioration of the situation and an ultimate default. Default may be averted because of the surety company's expertise in seeing projects to completion. To avoid default the surety company may:

- Provide trained personnel;
- Provide direct payment to subs, laborers, and suppliers; and/or
- Offer financial assistance to contractor.

While everyone would prefer to avoid default, it is not always possible--especially if the contractor or owner fail to talk about problems as they arise. In the event of default the surety company may, according to the particular language of the bond and construction contract:

- Retain the original contractor and:
 - Provide trained personnel,
 - Offer financial assistance, and/or
 - Provide payment for subs and suppliers;
- Re-bid the job to another contractor for completion;
- Pay the amount of loss up to the penal amount of the bond; or
- Pay the full penal amount of the bond.

Cost of Surety Bonds

The cost of the surety bond is referred to as the premium. The premium is a fee for the surety's prequalification, underwriting, and other services. Bonds typically cost 0.5% to 1% of the contract price, although rates vary from company to company. A payment bond generally is provided at no additional cost when issued in conjunction with a performance bond.

In charging this small fee for prequalification, the surety underwrites the contractor with the assumption that it will not incur a loss under the bond.

Examples of the Cost of Surety Bonds

Project Amount	Sample Bond Premium	Percent of Contract Amount
\$1 million	\$7,700-\$13,500	.77% to 1.35%
\$5 million	\$33,200-\$47,250	.66% to .95%
\$10 million	\$56,950-\$81,000	.57% to .81%
\$20 million	\$101,950-\$146,000	.51% to .75%

*Premiums are approximate, based on premiums from two of the nation's top 10 sureties.
NOTE: Some surety rates may be higher or lower than this example as rates vary from company to company.*

It is important to inquire about the rates when you are charged a premium. Rates may vary depending on the type of work the contractor normally performs. Also, some surety companies offer preferred rates for contractors with proven track records. It is important not merely to seek the absolute lowest rate in the industry. When evaluating the premium, contractors should take into account the opportunities and services that the surety company offers, such as customer service, support, confidence, and capacity to grow.

Most surety companies file their individual rate plans with the various insurance departments of the states in which they operate. Almost all surety companies file multiple rate plans along with prequalification requirements for each category. Most rate plans are financial requirements based on net worth, sales volume, and quality/frequency of financial reports.

Surety Bond Producer

The surety bond producer plays an essential role in helping a contractor obtain surety bonds. The surety bond producer is an integral part of the contractor's external advisory group, which includes attorneys, bank officers, and auditors. Surety bond producers, however, receive a commission on the bond premium only when the contractor is awarded the job and the bonds are issued.

By using his/her specialized knowledge of the construction industry, the surety bond producer prepares the contractor for the surety company's rigorous prequalification process. What are the qualifications of a great surety bond producer? The producer should:

- Match the needs and strengths of the contractor to the surety that will support him/her. To do that, the producer must understand the dynamics that will affect the surety's willingness to support the contractor and his/her business, then use that understanding to create and nurture a successful relationship between the contractor and the surety company.

- Offer sound business advice, formalized management consulting services, and technical expertise or introduce them to appropriate professionals or consultants. The producer may assist with developing a strategic/business plan, or introduce the contractor to bankers, CPAs, or attorneys to assist the contractor.
- Compile financial documents for submission to the surety company. In some cases, the producer may analyze the contractor's financial statements to determine the contractor's working capital, net worth, and current revenue recognition based on percent-project-completion before submitting it to the surety company.
- Develop written statements explaining net losses in a fiscal year, adjustments to retained earnings, and footnotes that may affect surety credit.
- Review contractor's contracts to help him/her avoid taking on excessive risk.
- Conduct background investigation of the contractor's past contractual obligations.
- Recommend a responsible line of credit consistent with the contractor's capabilities.
- Tailor the contractor's submission for the specific needs and particular requirements of the surety company and guide the contractor through a formal presentation to the surety company.
- Maintain communication channels between contractor and surety company with periodic reports on work progress, financial performance, and business plans.
- Maintain communication with contractor through site visits, social gatherings, industry meetings, or visits to contractor's office.
- Assist and advise the contractor on how to obtain or increase surety credit. A qualified surety bond producer can offer a candid appraisal of what the contractor can do to meet the surety company's underwriting standards.

Choosing a Surety Producer

Contractors should look for a producer that specializes in bonding for the construction industry. A surety bond producer should have the following qualities:

- A reputation for integrity and respect in the industry;
- Personal interest in the contractor's success;
- Ability to build solid relationships with surety underwriters;
- An understanding of the construction industry and the construction management process, including estimating, bidding, building and cost control systems, and an understanding of basic credit principles;
- Knowledge of accounting and finance, especially construction accounting procedures, ability to analyze financial statements, work-in-progress, and cash flow.
- Knowledge of construction, subcontracts, and contract law;
- Authority to issue bonds on the surety's behalf (within limits);
- Awareness of local, regional, and national construction markets;
- Experience in strategic planning and management practices to promote successful contracting; and
- The best surety bond producers are a part of the construction community through active involvement in and support of local and national construction and surety industry associations, such as the National Association of Surety Bond Producers (NASBP), Associated General Contractors (AGC), Associated Builders and Contractors (ABC).

Many surety bond producers also handle other lines of insurance applicable to managing construction operations, such as Builders' Risk Insurance, Mobile Equipment Insurance, Commercial General Liability, Personal Liability, Workers' Compensation, Insurance for Building and Contents, and Crime Coverage.

Surety Company

The Role of the Surety Underwriter

The surety underwriter is an employee of the surety company. The underwriter reviews the contractor's case by thoroughly analyzing the financial records and the contract to determine the contractor's ability to complete the project. The underwriter ensures that bond forms; application forms; forms for indemnity, subordination, collateral; and other agreements are completed and filed appropriately.

Choosing a Surety Company

As a contractor develops a strong business relationship with a surety bond producer, a relationship will also ensue between the contractor and the surety company. The surety company will help the contractor keep and increase its surety capacity. The surety industry is a people industry—it's about building and maintaining relationships. When choosing a surety company look for:

- surety's reputation in the marketplace;
- surety's experience with your type of work;
- easy and reliable access to representatives;
- open communication and prompt feedback;
- good relationships with producers; and
- effective claims handling.

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The Surety Association of America is a voluntary, non-profit, unincorporated association of companies engaged in the business of suretyship. SAA represents more than 500 companies that collectively underwrite the vast majority of surety and fidelity bonds in the United States, as well as a number of foreign affiliates. SAA is licensed as a rating or advisory organization and has been designated as a statistical agent by all states except Texas for the reporting of fidelity and surety experience.

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