Why Get A Bond?
Surety Bonds: A Valuable Risk Mitigation Tool

Surety is a unique form of insurance in which the surety company’s financial resources back the contractor’s commitment to enter into a contract with an owner. Surety bonds are a three-party agreement among the owner (obligee), the contractor (principal), and the surety company, and the surety company is obligated to both the obligee and the principal.

Surety bonds provide financial security and construction assurance to project owners by verifying that in the surety’s opinion the contractor is capable of performing the work and will pay certain subcontractors, laborers, and material suppliers. This is especially important on public projects where taxpayers’ dollars are at risk. During the prequalification process, the surety:

- Verifies the contractor’s ability to perform the contract and fulfill its financial obligations
- Completely reviews the contractor’s financial statements, capacity to perform, organizational structure, management, trade references, credit history, and banking relationships
- Checks that there are no “red flags” that could lead to contractor failure

In the event of contractor failure, depending on the terms of the bond, the surety may:
- Re-bid the project for completion
- Bring in a replacement contractor
- Provide technical and/or financial support to the existing contractor
- Pay the penal sum of the bond

Construction is a risky business, and contractors fail for many reasons. Having a surety as a partner often helps a contractor prevent and avoid those risks. When a contractor does fail, however, having surety bonds in place ensures that the owner and the subcontractor on the project do not bear the full risk of that failure. According to the U.S. Census Bureau, the value of construction put in place was about $787 billion in 2011. However, a contractor’s ability to secure some of that work, especially in the public sector, may be limited if he or she is unable to obtain a bid, performance, and payment bond. Fortunately, the surety industry is reaching out to new and emerging contractors to help them obtain their first bond, increase bonding capacity, and ultimately become better businesses. The ability to obtain surety bonds gives these contractors the opportunity to increase their contracting opportunities, compete for market share and grow.
Construction is a risk-filled enterprise, and even capable and well-established contractors can ultimately fail. According to BizMiner, of the 1,021,350 general contractors and operative builders, heavy construction contractors, and special trade contractors operating in 2014, only 722,281 were still in business in 2016—a 29.3 percent 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.

Big Contractors Can Fail

- Carillion
- J.A. Jones
- Morrison Knudsen
- Guy F. Atkinson
- Modern Continental
- Ballenger
- The Austin Company
- Dillingham Construction
- Encompass Services Group
- Fishbach & Moore
- IT Group
- JWP Group
- Morse Diesel
- Railworks Corporation
- Raymond International
- Stone & Webster
Benefits of Bonding

The surety industry is an integral part of the construction business. A good surety underwriter and surety bond producer can be two of a contractor’s greatest assets. The producer and underwriter are professionals who possess or have access to a wide variety of resources to assist contractors. They do all they can to see that a contractor remains viable. The surety team interacts with a cross section of the construction industry and can assist the contractor with:

- Professional references—The surety team knows accountants, bankers and lawyers who understand the construction business
- Corporate experience—Producers and surety company personnel can share their experience on issues facing a contractor
- Funding verification—This service becomes very important if a contractor is involved in private construction. Many contractors have faced bankruptcy because they did not ask the source of funding on private projects. The surety will insist on knowing the source and adequacy of funds before it will commit to bonding a project
- Contract reviews—Many sureties perform contract reviews to identify contract terms, general condition requirements, or anomalies in the specifications, or bond forms that may be onerous, unacceptable, or add undue risk to the project
- Continuity plans—Sureties can assist the contractor with a continuity plan to protect the contractor’s family, estate, partners, creditors, employees and assets

Financial Security & Construction Assurance

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.
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 that 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.