TEN THINGS YOU NEED TO KNOW ABOUT SURETY BONDING

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**WHAT IS SURETY?**

A surety bond is a three-party agreement where the surety company assures the obligee (owner) that the principal (contractor) will perform a contract. Surety bonds used in construction are called contract surety bonds.

**TYPES OF BONDS**

There are three primary types of contract surety bonds. The **bid bond** assures that the bid has been submitted in good faith and that the contractor intends to enter the contract at the price bid and provide the required performance and payment bonds. The **performance bond** protects the owner from financial loss in the event that the contractor fails to perform the contract in accordance with its terms and conditions. The **payment bond** assures that the contractor will pay certain workers, subcontractors, and materials suppliers.

**WHO IS SURETY?**

Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and insurance policies are risk transfer mechanisms regulated by state insurance departments. Of the 1,021,350 contractors in business in 2014, only 722,281 were still in business in 2016 – a 29.3% failure rate. Although surety rates are actuarially based and take into consideration the potential for loss, they also act as a fee for the surety’s extensive underwriting and prequalification service.

**SURETY IS REGULATED**

In 1894 Congress passed the Heard Act to protect federal projects from contractor default. The Heard Act was supplanted by the Miller Act in 1935, the current version of which requires performance and payment bonds for construction contracts in excess of $100,000 (and by regulation $150,000) and payment protection for contracts between $30,000 and $100,000. A corporate surety company issuing these bonds must be listed as a certified surety on the U.S. Department of Treasury List, Circular 570. Also, 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.” Owners of private construction also manage risk by requiring surety bonds.
MANAGE RISK

Construction is a risky business. Surety bonds offer assurance that the contractor is capable of completing the contract on time, within budget, and according to specifications. Requiring bonds not only reduces the likelihood of default, but with a surety bond, the owner has the peace of mind that a sound risk transfer mechanism is in place. The burden of construction risk shifts from the owner to the surety company.

WHAT’S THE COST?

Surety bond premiums vary from one surety to another, but can range from 0.5% to 3% (closer to 3% if the Small Business Administration's Surety Bond Guarantee is used) of the contract price and vary depending on the size, type, and duration of the project and the contractor. Typically, there is no charge for a bid bond if performance and payment bonds are required on the project. In many cases, the cost of a payment bond and a 12-month maintenance bond is included with the purchase of a performance bond.

PREQUALIFICATION

The surety company’s rigorous prequalification of the contractor protects the project owner and offers assurance to the lender, architect, and everyone else involved with the project that the contractor is able to translate the project's plans into a finished project. Surety companies and surety bond producers have been evaluating contractor and subcontractor performance for more than a century. Their expertise, experience, and objectivity in prequalifying contractors is one of a bond's most valuable attributes. 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
- 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
- An established bank relationship and line of credit.
Contractor default is an unfortunate, and sometimes unavoidable, circumstance. In the event of contractor failure, the owner must formally declare the contractor in default. The surety conducts an impartial investigation prior to settling any claim. This protects the contractor's 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. That owners have been shielded from risk is evidenced by the fact that surety companies have paid more than $13.8 billion from 1995 to 2014 due to contractor default, according to The Surety & Fidelity Association of America in Washington, DC. In 2014, the surety industry paid more than $84 million is losses on private construction and has paid more than $2 billion since 1995.

When bonds are specified in the contract documents, it is the contractor's responsibility to obtain them. The contractor generally 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 will be adjusted for the change in contract price. Contract surety bonds are a wise investment – providing qualified contractors and protecting public owners, private owners, and prime contractors from the potentially devastating expense of contractor and subcontractor default.

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 because the surety company likely requires personal or corporate indemnity from the contractor
• Subcontractors have no need to file mechanics' liens on private projects when a payment bond is in place
• Bonding capacity can help a contractor or subcontractor grow by increasing project opportunities and providing the benefits of assistance and advice of the surety bond producer and underwriter
• Surety companies may prevent default by offering technical, financial, or management assistance to a contractor
• The surety company fulfills the contract in the event of contractor default.
SURETY AND FIDELITY BONDS:

PROTECTING CONSUMERS,
TAXPAYERS AND BUSINESSES

www.surety.org

The Surety & Fidelity Association of America (SFAA) is licensed as a rating or advisory organization in all states and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA serves as a trade association of more than 420 insurance companies that write the vast majority of surety and fidelity bonds in the U.S.