

OAME/AGC COLLABORATION ISSUE #3

BONDING



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INTRODUCTION

In April 2001, the Oregon Association of Minority Entrepreneurs (OAME) and the Associated General Contractors, Oregon-Columbia Chapter (AGC) entered into a collaborative working relationship to find solutions to issues of concern to women- and minority-owned and emerging small construction companies.

OAME surveyed its construction contractor members to develop a list of issues. From this list, a representative group from each organization determined that four would be of greatest benefit to both groups to pursue. Those four issues were prioritized, and OAME and AGC committed to addressing each issue and producing a report of their findings at the conclusion. The issues are:

- Prompt Payment
- Exploring opportunities for minority contractors to grow capacity (such as joint venturing)
- Bonding
- Developing an AGC system for reporting minority contractor utilization

This whitepaper is the result of work completed by following members of OAME and AGC:

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| Sam Brooks, OAME | Doug Overholser, WG Moe & Sons |
| Jorge Guerra, OAME | Cleophas Limbrick, RJ & Co. Property Maintenance |
| May Saephan, OAME | Don Geddes, Walsh Construction |
| Faye Burch-Wilson, FM Burch & Associates | Darrin Oelke, Travelers Bond |
| Ed Wilson, Ampere Electric | Scott Pyritz, Safeco Insurance Companies |
| James Cason, JEC Mechanical | Gary Alongi, Aldrich Kilbride & Tatone |
| Tony Jones, Housing Development Center | Karla Holland, AGC |
| Don Shanklin, BR&R Insurance & Bonding | Cindy Catto, AGC |

It is the intent of both OAME and AGC to use the findings of this white paper to educate the contracting community about what surety bonds do, why they are required, and how contractors obtain them.

PROBLEM DEFINITION

Small construction companies, especially those that are new ventures, are often faced with the requirement that they provide a bond or other evidence of “certainty” that they are able to perform their portion of a project. Because bonding is different from the types of insurance with which most people are familiar, the requirements for bonding are often misunderstood and interpreted as an insurmountable barrier to small contractors’ success and growth.

While it is true that it can be more difficult for a small, emerging contractor to obtain bond credit, the fact that is not widely understood is that it is not just size that determines a company’s ability to get a bond. A track record of successful performance, sound financial practices, and a good working relationship with a bond agent are probably more critical than a contractor’s size.

The intent of this whitepaper is to “demystify” bonding and to provide resources to assist contractors with their bonding needs.

BONDING OVERVIEW

The information provided below has been excerpted from the Surety Information Office website, www.sio.org/contractor/contractor1.html

Why Do Contractors Need Bonds?

Since 1893, the U.S. Government has required contractors on federal public works contracts to obtain surety bonds to guarantee that they will perform such contracts and pay certain labor and material bills. The current federal law mandating surety bonds on federal public works is known as the Miller Act (40 U.S.C. Section 270a et. seq.). It requires performance and payment bonds for all public work contracts in excess of \$100,000 and payment protection, with payment bonds the preferred method, for contracts in excess of \$25,000. 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.”

Oregon’s bonding requirements for public improvement projects are found in ORS 279.

How Do Bonds Work?

How owners evaluate and manage risk on construction projects and make fiscally responsible decisions to ensure timely project completion is key to success. No construction project owner, public or private, can afford to gamble on a contractor whose responsibility is uncertain or who could end up bankrupt halfway through the job. And how can a public agency using the low-bid system in awarding public works contracts be sure the lowest bidder is dependable?

Surety bonds provide financial security and a construction “guarantee” by assuring project owners that contractors will perform the work and pay their subcontractors, laborers, and material suppliers. A surety bond is a risk transfer mechanism where the surety company guarantees to the obligee (the owner) that the principal (the contractor) will perform a contract. There are three primary types of surety bonds used in construction: bid, performance, and payment bonds.

Types of Bonds

The **bid bond** provides financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the price bid and will provide the required performance and payment bonds.

The **performance bond** protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.

The **payment bond** guarantees that the contractor will pay certain subcontractors, laborers, and material suppliers on the project.

Financial Security and Construction Guarantee

While surety bonds are mandated by law on public works projects to protect taxpayer dollars, the use of surety bonds on privately-owned construction projects is at the owner's discretion. Alternative forms of financial security, such as letters of credit and self-insurance, don't provide the performance and payment protection of a surety bond or assure a competent contractor. With a surety bond, 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. Subcontractors may be required to obtain bonds to help the prime contractor manage risk, particularly if the subcontractor is a significant part of the job or a specialized contractor that is difficult to replace.

Functions of Bonds

Contract surety bonds perform the following functions:

- Assure project completion;
- Assure a qualified contractor on the project;
- Guarantee that certain laborers, suppliers, and subcontractors will be paid;
- Relieve the private owner from the risk of financial loss arising from liens filed by certain unpaid laborers, suppliers, and subcontractors;
- Smooth the transition from construction to permanent financing by eliminating liens on private projects;
- Help the contractor grow by increasing construction project opportunities and offering assistance and advice;
- Provide intermediaries—the surety company and surety bond producer—to whom the owner can air complaints and grievances;
- May lower the cost of construction by facilitating the use of competitive bids; and
- Screen out unqualified contractors and irresponsible competition.

MEETING UNDERWRITING REQUIREMENTS

Because of the unique relationship between the surety and the contractor, underwriting a bond is a much more subjective exercise than underwriting for other types of insurance. Property and casualty underwriters have manuals to which they refer when quoting insurance premiums—that is not the case with bond underwriting. Contractors should be mindful of the following actions, which will enhance the ability to be bonded.

Select a Qualified Bond Agent

The first, and perhaps most important, step in the bonding process is securing the services of a qualified bonding agent that has experience with the construction industry. (See Attachment 1 for a list of agents who specialize in construction bonding for small emerging contractors.)

Although surety bonding is a part of the insurance industry, bonding is much closer to banking than it is to traditional liability or property insurance. Because of that, the surety company is more interested in a contractor's *credit worthiness* than an auto or home insurer might be. In effect, the surety company is *lending* its own financial resources (via the bond) to guarantee that the contractor will make payments to employees, subcontractors, and suppliers, and will complete the project as required by the contract. Unlike other types of insurance, which offer deductibles and charge premiums based on the probability of expected loss, *surety companies do not expect a loss*. The surety bond premium is a fee for underwriting.

Establish a Relationship With a Bank

Every contractor needs to establish at least a modest line of credit with a bank to be successful in today's construction industry. Whether a contractor is operating as a general or subcontractor, cash flow issues exist on nearly every project. Bond underwriters will want assurance that a contractor can meet financial obligations in spite of an owner being late with payment.

Get Financial Reports in Order

In addition to having a bonding agent and a banker, every contractor should invest in the expertise of a certified public accountant with construction experience. It is nearly impossible for a bonding agent to present a contractor to a surety company without good financial reports. The financial report package should include a balance sheet, income statement, statement of cash flows, accounts receivable and payable schedules, work-in-progress schedule, and a listing of contracts completed. Sureties prefer audited or review level financial statements for a minimum of three years. It is important to note that not all CPAs have construction experience; as with bonding agents, construction accounting is a specialized segment of the industry. Contractors need this specialized experience on their team.

Start Small and Build Capacity

Small and emerging businesses can avoid many of the problems that will result in an inability to obtain bonding if they start with small projects and build a history of success. Growing too fast or taking on too large of a project is the surest way to experience cash flow and performance problems.

Negotiate Reasonable Payment Terms

One way to control potential cash flow problems is to negotiate payment terms on sub and supplier contracts that are consistent with the payment terms between the owner and general contractor, or the general contractor and first tier subcontractors.

Pre-qualify for Your Bond *Before* You Need It

Contractors need to establish their bonding capacity well in advance of the need for an actual bond for a project. The pre-qualification process is an in-depth look at the contractor's business operations. Before issuing a bond, the surety company must be fully satisfied, among other criteria, that the contractor has:

- Good references;
- Experience matching the contract requirements;
- The ability to obtain the necessary equipment to do the work;
- The financial strength to support the desired work program;
- An excellent credit history; and
- An established bank relationship and line of credit.
- CPA-reviewed financial statements with the appropriate supplemental information.

ALTERNATIVES TO STANDARD BOND MARKETS

The three Cs of surety underwriting are:

- Capital—does this contractor have the ability/resources to manage the costs of the project?
- Capacity—can the contractor do the work?
- Character—do I want this contractor as my partner?

What happens if a contractor has capacity and character, but lacks the necessary capital? In this case, it will be difficult, if not impossible, for even the best bond agent to obtain coverage in the standard market.

Fortunately, there are alternatives to bridge the gap.

Secured Bonding

Secured/collateralized bonding has been around for many years; however the advent of computer technology and the hard market has created a proliferation in the number of companies entering this market. It is easier than ever to work through the qualification process for this kind of bonding. It is an alternative for new companies who do not have an established history or those who have suffered a significant financial setback. While it is true that a contractor's assets are pledged as security with a standard bond, a surety is required to initiate legal proceedings against a contractor to collect. A secured bond allows the bonding company direct access to the pledged asset. The typical collateral for these bonds is the contractor's home or letter of credit.

Collateralized bonds are being used by general and specialty contractors. In cases where the contractor does not have sufficient assets, the collateral for the bond can be offered by a family member or key employee on behalf of the contractor.

Funds Control

When the size of a project is larger than a collateralized bond can cover, another option is for the project owner to make payments into a third-party controlled disbursement account. That third party then reviews all payment requests and makes the payments from the account.

SBA Bonding

The Small Business Administration offers a federally guaranteed bonding program; however, it rarely used by bonding agents because of the large amount of paperwork that is required. There are two different programs:

- Plan A is a 90 percent federal guarantee and requires extensive paperwork
- Plan B is an 80 percent federal guarantee and it requires less paperwork

Generally, bond agents try to avoid using the SBA programs because of the amount of additional work that is required to obtain a bond. SBA bonds are also written at a higher rate and have additional fees attached.

Subcontractor Bonding

Requiring that a major subcontractor bond his portion of the project is an alternative for a general contractor who has limited bonding capacity to secure the required bonds. For example, if the project includes a significant mechanical subcontract, the general can require that the mechanical subcontractor bond that portion of the work, thereby reducing the risk to the general and enhance the general's ability to secure a bond..

Shifting Equipment Costs

An option for a subcontractor with a significant equipment cost in their portion of the project is to negotiate with the general contractor to directly purchase the equipment to be installed. By doing so, the amount of the subcontractor's bond will be significantly reduced.

Even though the above techniques can provide short-term solutions, the goal should always be to move from the non-standard to the standard bond market. The only way to accomplish this is to improve profitability, financial reporting, and the financial base of the company over a reasonable period of time.

CONCLUSIONS

There is significant confusion amongst M/W/DBE and ESB contractors about the importance of being “bondable.” The requirements of bonding (track record of success, financial systems, business equity) are often seen as barriers to success when, in fact, they should be viewed as goals for every contractor to achieve. Even if a new contractor cannot qualify for a standard surety bond, there are alternatives available that will allow him/her to build the business gradually, but the proper business policies and procedures must be put into place.

The keys to bonding success depend largely on a contractor developing a business relationship with three key partners—a bonding agent, a construction CPA, and a banker—and on growing the business slowly.

NEXT STEPS

1. Distribute whitepaper in April via AGC and OAME website
2. Provide a “Basics in Bonding” seminar at OAME
3. Direct contractors who are experiencing difficulty in securing bonds to the resources within OAME and AGC to assist them

RESOURCES

Bonding Agents:

*Indicates an OAME or AGC member

Information provided by the Surety Association of Oregon

Agencies

* Anchor Insurance & Surety, Inc.

1201 SW 12th Ave Ste 500

Portland, OR 97025

Contact - Pat Dooney, Rick Kowalski, Chuck Hersh, Phil Forker, Ken DeLooze, Gene Dietzman,
or Ray Paiement.

Phone: 503-224-2500

Biggs Insurance Services

P.O. Box 189

Vancouver, WA 98666

Contact - Jon Courser

jon.courser@biggsinsurance.com

Phone: (360) 695-3301

Fax: (360) 696-2232

* BR&R Insurance & Bonding

4322 SE 182nd Ave

Gresham, OR 97030

Contact - Don Shanklin

Phone: 503-666-5544

Fax: 503-676-1326

don.shanklin@brrins.com

Schauer mann Insurance

PO Box 327

Forest Grove, OR 97116

Contact – Jorge Fred

Phone: 503-357-7111

insurance@schauer mann.com

* USI Northwest, Inc.

700 N.E. Multnomah, suite 1300

Portland, OR 97232

Contract - James S. Ewald

Phone: 503-295-8323

jim.ewald@usi.biz

Construction CPAs:

*Indicates an OAME or AGC member

Information provided by the Surety Association of Oregon

* Aldrich, Kilbride & Tatone
5335 SW Meadows Road #401
Lake Oswego, OR 97035-3115
Phone: 503-620-4489
Fax: 503-624-0817

* Hoffman, Stewart & Schmidt, P.C.
111 SW Fifth Ave., Suite 1500
Portland, OR 97204
Phone: 503-220-5900
Fax: 503-220-8836

* Moss Adams, LLP
222 SW Columbia, Suite 400
Portland, OR 97201
Contract - Mike Hawkey, CPA
Phone: 503-242-1447
Fax: 503-274-2789

Are You Protected?

Do Contractor Default Insurance and Subcontractor Default Insurance Stand Up to Surety Bonds?

Facts to help subcontractors understand the differences between surety bonds and contractor and subcontractor default insurance products.

RISK TRANSFER

As general contractors look for ways to manage risk, the promise of a risk management tool that is faster, cheaper, and better is tempting. If the contractor on your next construction project is considering a subcontractor default insurance product, there are facts you need to know.

Contract surety bonds are effective tools for shifting the risk of contractor or subcontractor failure to a surety company. A surety bond is a three-party agreement under which one party (the surety) guarantees to another (the obligee) that a third party (the principal) will perform a construction contract. The obligee is the entity or individual who is the beneficiary of the surety bond. When a prime contractor is required to provide a contract surety bond, the obligee is generally the owner of the project that the contractor will construct and the prime contractor is the principal. When a subcontractor is required to provide a contract surety bond, the obligee is generally the prime contractor and the subcontractor is the principal.

Surety bonding is a careful, rigorous, and professional process in which the surety company and producer prequalify the principal, providing the obligee with assurance that the principal will perform according to the terms and conditions of the contract. Both owners and general contractors manage risk by requiring surety bonds. In both cases, subcontractors are protected from others' default and are assured payment.

A **Performance Bond** states that the principal will perform its contract in accordance with the contract documents. When a prime contractor requires you to obtain a performance bond, it protects him/her from financial risk should you default on your obligation to perform the job according to the terms and conditions of the contract. A **Payment Bond** states that persons supplying labor and materials on a project will be paid subject to any restrictions and limitations imposed by statute, the contract or subcontract, or the bond. A payment bond gives certain subcontractors, laborers, and suppliers the right to



Contract surety bonds are effective tools for shifting the risk of contractor or subcontractor failure to a surety company.

make a direct claim against it.

While contractor and subcontractor default insurance products are marketed as “cost effective alternatives to traditional performance and payment bonds,” they provide minimal protection to contractors against default and offer no protection to subcontractors, laborers, or suppliers. A typical contractor or subcontractor default insurance policy is a two-party agreement between the insured (the owner or contractor) and the insurer. The policy reimburses the insured for a “qualified loss,” which usually is defined as the costs and expenses above a certain amount the owner or contractor must pay as a result of contractor or subcontractor default.

You should be wary of these products. If the covered contractor or subcontractor defaults, you have no right to file a claim directly with the insurer.

PREQUALIFICATION

One of the most valuable services of the surety bond is prequalification of bidders - either contractors or subcontractors. Prequalification is a thorough process in which the surety underwriter and producer analyze the bidder's:

- Financial strength and credit history;
- Experience and reputation;
- Exposure and progress on other contracts; and
- Ability to perform the work; as well as
- Contract documents; and
- Size and location of the work.

There is no third-party prequalification performed with contractor or subcontractor default insurance. Rather, the obligee is responsible for determining the capability and capacity of the bidders to complete the contract. As a subcontractor, you need to be assured that the prime contractor is able to perform the prime contract.

As for projects with subcontractor default insurance, you may face undue competition from unqualified subcontractors. If the performance of all subcontractors is covered under the default insurance policy, the —prime contractor could lose all incentive to consider a subcontractor's ability to perform the contract. The general contractor could focus only on the lowest price rather than qualifications.

CLAIMS

If the principal defaults, and is covered by a performance and payment bond, the obligee is assured that the contract will be completed and that subcontractors and suppliers will be paid. When subcontractor default occurs, the surety offers support to the prime contractor. If a bonded subcontractor defaults, the surety deals with unpaid creditors, suppliers, and laborers and administers the subcontractor's work to completion. The surety may bring in a re-



One of the most valuable services of the surety bond is prequalification of bidders.

placement subcontractor to complete the work, finance the present subcontractor to completion, or negotiate a financial settlement with the contractor and issue payment.

Should a prime contractor default on a bonded project, the subcontractors, laborers, and suppliers are protected. Not only does the surety ensure continuation of the project, but subcontractors, laborers, and suppliers may file a claim for payment directly with the surety.

Contractor default insurance policies do not appear to cover subcontractors', laborers', and suppliers' claims of non-payment. Consequently, they have no right to make claims on the policy. Because the owner or contractor must first pay losses, and then try to recoup damages from the insurer, the owner's or contractor's cash flow is negatively affected, which in turn could affect the project.

COMBINING AGREEMENTS

By themselves, performance and payment bonds offer you the protections you need to assure fair competition and performance and payment guarantees in the event of contractor default. If an owner has entered into a combining agreement and purchases default insurance in addition to performance and payment bonds, rather than in place of them, you should have payment protection.

The surety bond premium is a fee for providing underwriting services, and therefore provides protection for 100% of the contract amount. However, some combining agreements may dilute the protection provided by surety bonds. In one instance, the insurer offered to bond the prime contractor and "eligible" subcontractors and suppliers for a predetermined percentage of a loss, not the full 100% payment bond protection.

Beware of combining agreements that coordinate coverage of surety bonds with default insurance. These agreements usually stipulate that a payment bond claim may be made under the default insurance policy or under the bond, but not both. However, the insured must make the claim. The subcontractor may not make a direct claim and does not play an active role in the claims process. Keep in mind that the project's claims history affects the final default insurance premium, so owners and contractors may be reluctant to file claims.

It doesn't make sense to purchase both. All things considered, surety bonds provide the most protection at a price comparable to default insurance products.



Knowing just what you are purchasing is the key to making an informed decision on the best product for your project.

SURETY BONDS BENEFIT SUBCONTRACTORS

An established relationship with a surety company can help your company grow. Bondable subcontractors are:

- Able to work on public projects;
- Qualified for a certain type and level of work; and
- Able to benefit from the expertise of the surety company and surety bond producer.

When default insurance is used as an alternative to surety bonds, the owner foregoes protections provided by a payment bond and leaves subcontractors and suppliers exposed. Surety bonds and other types of insurance have their place in the construction industry; both are necessary components, but each serves a different purpose. Knowing which one offers you the most protection is essential.

COMPARISON CHART:

SURETY BONDS VS. A TYPICAL DEFAULT INSURANCE POLICY

| Issues | Surety Bonds | Default Insurance |
|---|---|---|
| Prequalification & Underwriting Services | <ul style="list-style-type: none"> • Impartial, rigorous process performed by surety underwriter and producer to screen out unqualified contractors | <ul style="list-style-type: none"> • Prequalification performed by owner or contractor • Subcontractors have no assurance of ability of contractor to perform the work |
| Coverage | <ul style="list-style-type: none"> • Performance & payment bonds each cover 100% of contract price | <ul style="list-style-type: none"> • No protection for subcontractors |
| Claims | <ul style="list-style-type: none"> • If prime contractor default occurs, the surety completes, arranges for, or pays for contract completion up to the amount of the bond • Subcontractors & suppliers are provided direct payment protection | <ul style="list-style-type: none"> • Owner or contractor must manage completion of the contract, then file claim with the insurer • Subcontractors & suppliers may not file a direct claim with the insurer |
| Risk | <ul style="list-style-type: none"> • Surety holds the risk for contract completion & payment to subcontractors & suppliers | <ul style="list-style-type: none"> • Owner or contractor retains portion of the risk through deductibles & co-payments |
| Legal | <ul style="list-style-type: none"> • Required by federal & state law on public projects • Established history of case law • Terms & conditions defined in statutes, regulations, & case law | <ul style="list-style-type: none"> • Not required by federal or state governments • No history of case law, legal precedence, or claims history • Terms & conditions not defined outside of policy by statutes, regulations, or case law |

For more information about contract surety bonds contact:



Surety Information Office
5225 Wisconsin Ave., NW #600
Washington, DC 20015-2014
(202) 686-7463
Fax: (202) 686-3656
www.sio.org • sio@sio.org

The information source on contract surety bonds. SIO is supported by SAA and NASBP.



The Surety Association of America
1101 Connecticut Ave., NW #800
Washington, DC 20036
(202) 463-0600
Fax: (202) 463-0606
www.surety.org
information@surety.org

SAA is a voluntary, non-profit, unincorporated association of companies engaged in the business of suretyship. It presently has approximately 600 member surety companies, which collectively underwrite the overwhelming majority of surety and fidelity bonds in the US, and 7 foreign affiliates. SAA is licensed as a rating or advisory organization in all states, DC, and Puerto Rico, and has been designated by all state insurance departments except Texas as a statistical agent for the reporting of fidelity and surety experience.



National Association of Surety Bond Producers
5225 Wisconsin Ave., NW #600
Washington, DC 20015-2014
(202) 686-3700
Fax: (202) 686-3656
www.nasbp.org • info@nasbp.org

NASBP is the international organization of professional surety bond producers and brokers. NASBP represents over 5,000 personnel who specialize in surety bonding, provide performance and payment bonds for the construction industry, and issue other types of surety bonds for guaranteeing performance, such as license and permit bonds. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.

How To Obtain Surety Bonds

PREMISE

It's important to realize that each surety company has its own underwriting standards and requirements. But there are fundamentals that are common to underwriting surety bonds.

THE PROCESS

Since most companies that issue surety bonds work through a surety bond producer, also known as agents and brokers, your first step is to discuss your plans with one of these representatives. You will find that a producer who specializes in insurance and bonding for the construction industry will likely be the best qualified to assist you. (Please call the National Association of Surety Bond Producers at (202) 686-3700; www.nasbp.org to obtain a listing of bond producers in your area.)

1. The surety bond producer will guide you through the bonding process and assist you in establishing a business relationship with a surety company.
2. Surety bonds are not provided in the same manner as off-the-shelf insurance products which can be purchased. Contractors must qualify for surety bonds.
3. You may find that it's necessary to spend a lot of time and effort establishing a good relationship with a surety company. Since the surety is guaranteeing your company's bid, performance, and payment, it needs to gather and carefully analyze a lot of information about your firm.
4. Before issuing a bond, the surety wants to be satisfied that your company is a well managed, profitable enterprise, which keeps promises, deals fairly, and performs obligations in a timely manner.
5. Your surety bond producer may need the following information in order to prepare your submission to the surety:
 - an organizational chart that shows your key employees;
 - detailed resumes of yourself and your key people;
 - a business plan outlining type of work, growth, and profit objective;
 - a list of your largest completed jobs and the gross profit earned;



Before issuing a bond, the surety wants to be satisfied that your company is a well managed, profitable enterprise, which keeps promises, deals fairly, and performs obligations in a timely manner.

- subcontractor and supplier references;
 - evidence of a line of credit at your bank; and letters of recommendation from owners, architects, and engineers.
6. Fiscal year end statements are vital and should include:
- the accountant's opinion page;
 - the balance sheet which shows your assets, liabilities and net worth;
 - an income statement which measures how well the business performed
 - statement of cash flow which discloses the cash flow movements;
 - schedule of contracts in progress and contracts completed; and
 - a schedule of general expenses to show overhead expenses.

Sureties prefer audited fiscal year end statements, but there are occasions when a surety may accept a review statement. Sureties may also require you to sign a personal indemnity agreement to assure you will stand behind your firm.

CONCLUSION

Even after all this information is provided to the surety, there is no guarantee it will result in an approval. The bond will be given only if the surety feels the contractor is qualified to successfully perform the contract and has the financial capacity to withstand the numerous risks involved in the construction business. Your decision to seek surety bonds should be based on long term considerations. To obtain bonds, some changes in the way your firm does business may be necessary and these changes could have certain costs.

SOURCE: Your First Bond, published by The Surety Association of America and the National Association of Surety Bond Producers. Another publication on this topic—Obtaining, Maintaining & Effectively Using Surety Credit—is available from NASBP for a nominal fee.

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The Surety Association of America

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Washington, DC 20036
(202) 463-0600
Fax: (202) 463-0606
www.surety.org
information@surety.org

SAA is a voluntary, non-profit, unincorporated association of companies engaged in the business of suretyship. It presently has approximately 600 member surety companies, which collectively underwrite the overwhelming majority of surety and fidelity bonds in the US, and 7 foreign affiliates. SAA is licensed as a rating or advisory organization in all states, DC, and Puerto Rico, and has been designated by all state insurance departments except Texas as a statistical agent for the reporting of fidelity and surety experience.



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SURETY BONDS VERSUS BANK LETTERS OF CREDIT

SURETY BONDS

BANK LETTERS OF CREDIT

DEFINITIONS

- A contract surety bond is a three-party agreement whereby the surety guarantees to the obligee (the owner) that the principal (the contractor) is capable of performing the contract.
- Performance of the contract, which is the subject of the bond, determines the rights and obligations of the surety and the obligee.
- A **performance bond** protects the owner from non-performance and financial exposures should the contractor default on the contract. It is directly tied to the underlying contract and if the contractor is unable to perform the contract, the surety has responsibilities to the owner and contractor for project completion.
- A **payment bond**, sometimes called a labor and material bond, protects certain subcontractors, laborers, and material suppliers against nonpayment by the contractor. Generally, these claimants may seek recovery directly from the surety company under the payment bond. It also protects the owner from these subcontractors asserting their right to file a lien against the owner's project for non-payment.
- A bank letter of credit (LOC) is a cash guarantee to the owner. The owner can call on the letter of credit on demand without cause. Once called upon, the letter of credit converts to a payment to the owner and an interest-bearing loan for the contractor.
- A letter of credit has no guarantee of project completion. The performance of the underlying contract has no bearing on the bank's obligation to pay on the letter of credit.
- A **conditional letter of credit** may require some burden of proof by the owner that the contractor has failed to perform before the bank will pay on the letter of credit.
- A **standby letter of credit** is normally used for open accounts and deals only with payment of documented sums within a stated time period.
- A **transactional letter of credit** applies to one specific transaction.
- Most letters of credit are **irrevocable**, which means that both parties must agree to any changes to the letter of credit. Changes must be documented by an amendment signed by both parties.



A performance bond protects the owner from non-performance and financial exposures should the contractor default on the contract.

PREQUALIFICATION

- A surety company and producer assess the contractor's entire business operation, checking for adequate financial resources, necessary experience, organization, existing work load and its profitability, and management skills to carry on the business and successfully complete the project for which the bond is required. When it issues a bond, the surety company has verified that the contractor is capable of performing the job for the stated price and in the time allotted. This process is designed to disqualify contractors who are unable or unqualified to complete the project for any number of reasons. Contractors who cannot qualify for a surety bond but can provide a letter of credit may not possess all the necessary ingredients to perform the work successfully to completion.
- The banker examines the quality and liquidity of the collateral available to the bank in case there is a demand on the letter of credit. If the banker is satisfied that the contractor can reimburse the bank if demand is made upon the letter, there is no further prequalification.

BORROWING CAPACITY

- With few exceptions, performance and payment bonds are issued on an unsecured basis. That is, they are usually provided on the strength of corporate and personal signatures of the owners of the construction company. The issuance of bonds has no effect on the contractor's bank line of credit and in some instances, can be viewed as a credit enhancement. Unused borrowing capacity can be viewed as an off -balance sheet strength.
- Subcontractors and material suppliers may be more willing to extend credit to the contractor when they know a payment bond has been issued on a project to protect them.
- Specific assets are pledged to secure bank letters of credit. Bank letters of credit diminish an existing line of credit, and are reflected on the contractor's financial statement as a contingent liability. Having assets tied up, or an available line of credit diminished, is counter-productive to both the owner and contractor. The contractor's cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected when liquid assets are pledged to a bank or the bank reduces its borrowing capacity as a result of the issuance of a letter or credit.
- Subcontractors and materials suppliers may be reluctant to extend credit to the contractor for labor or materials since they have no access or rights to funds available from the letter of credit.



When it issues a bond, the surety company has verified that the contractor is capable of performing the job.

DURATION

- Surety bonds remain in force for the duration of the contract plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.
- A letter of credit is usually date specific, generally for one year. Letters of credit may contain “evergreen” clauses for automatic renewal, with related fees.

HOW TO OBTAIN

- When a construction project owner specifies a surety bond in the construction contract, the contractor is responsible for obtaining the bond. Most surety companies issue bonds through knowledgeable surety bond producers, also called agents or brokers. Members of the National Association of Surety Bond Producers (NASBP) are especially qualified to assist contractors with their bonding needs. Contact NASBP at (202) 686-3700; nasbp@nasbp.org for a list of surety bond producers.
- The contractor obtains the letter of credit through a banking or lending institution and includes the cost of the letter of credit to the owner in the contract bid price.

COST

- Generally ½ - 2% of contract price for contractors with established bonding credit. The premium includes a 100% performance bond, 100% payment bond, plus a one-year maintenance period.
- The bond premium is included in the contractor’s bid price.
- Cost is generally 1% of the contract amount covered by letter of credit - e.g. if LOC covers 10% of contract, Cost = 1% x (10% x Contract Amount).
- The cost of the letter of credit is included in the contractor’s bid price.

COVERAGE

- 100% performance bond of the contract amount.
- 100% payment bond protects certain subcontractors, laborers, and materials suppliers and protects owner against liens.
- At least 10% coverage for maintenance of defects the first year after completion.
- Before paying, the surety investigates claims for payment, verifying their validity.
- The letter of credit may be obtained for any percentage of the contract, but 5% to 10% is typical.
- No protection/guarantee that subcontractors, laborers, and materials suppliers will be paid in event of contractor default. They may file liens on the project.
- The owner must determine which claims are valid.



Most surety companies issue bonds through knowledgeable surety bond producers.

CLAIMS

- The surety company has obligations to both the owner and the contractor. If the contractor and owner disagree on contract performance issues and the owner declares the contractor in default, the surety must investigate the claim.
- The surety has several alternatives to respond should the contractor be in default:
 1. Finance the original contractor or provide support necessary to allow the contractor to finish the project;
 2. Arrange for a new contractor to complete the contract;
 3. Assume the role of the contractor and subcontract out the remaining work to be completed; or
 4. Pay the penal sum of the bond.
- With payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers.
- The bank will pay on a letter of credit upon demand of the holder. The holder or beneficiary must make a demand prior to the expiration date. No funds are available after the expiration date, even for liabilities incurred prior to expiration. There is no obligation to complete the project.
- There is no completion clause in a letter of credit. The task of administering completion of the contract is left to the owner.
- The owner must determine the validity of claims by subcontractors, laborers, and materials suppliers. If there is not enough money from the letter of credit to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.

INTERNATIONAL

- Surety companies are writing more contract surety bonds overseas as they gain recognition as a more comprehensive coverage to guarantee completion of construction projects within the term of a contract.
- Currently, more commonly accepted overseas. Some foreign project owners may not accept a surety bond.

For more information about contract surety bonds contact:



Surety Information Office
5225 Wisconsin Ave., NW #600
Washington, DC 20015-2014
(202) 686-7463
Fax: (202) 686-3656
www.sio.org • sio@sio.org

The information source on contract surety bonds. SIO is supported by SAA and NASBP.



The Surety Association of America
1101 Connecticut Ave., NW #800
Washington, DC 20036
(202) 463-0600
Fax: (202) 463-0606
www.surety.org
information@surety.org

SAA is a voluntary, non-profit, unincorporated association of companies engaged in the business of suretyship. It presently has approximately 600 member surety companies, which collectively underwrite the overwhelming majority of surety and fidelity bonds in the US, and 7 foreign affiliates. SAA is licensed as a rating or advisory organization in all states, DC, and Puerto Rico, and has been designated by all state insurance departments except Texas as a statistical agent for the reporting of fidelity and surety experience.



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NASBP is the international organization of professional surety bond producers and brokers. NASBP represents over 5,000 personnel who specialize in surety bonding, provide performance and payment bonds for the construction industry, and issue other types of surety bonds for guaranteeing performance, such as license and permit bonds. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.

SBA's Surety Bond Guarantee Program – Helping Contractors Grow

An established relationship with a surety company and surety bond producer helps small contractors grow by increasing contracting opportunities, especially in public sector construction. Many surety bond companies recognize the importance of providing bonds to small, minority, and emerging contractors and have developed programs that enable them to obtain bonds. The first step to obtaining a bond is to contact a surety bond producer in your area. For a list of professional surety bond producers, contact the Surety Information Office at (202) 686-7463 or sio@sio.org.

SBG PROGRAM OVERVIEW

For more than 20 years, the U.S. Small Business Administration (SBA) has operated the Surety Bond Guarantee (SBG) program. Its purpose is to help small and emerging contractors who have the knowledge and skills necessary for success but lack the experience or financial strength to obtain bonds. Through the SBG program, the SBA guarantees bid, performance, and payment bonds issued by surety companies to small and emerging contractors who are unable to obtain surety bonds through regular commercial channels. The SBA reimburses the surety a percentage of loss if the contractor defaults. This government guarantee allows sureties to write bonds for contractors who would not otherwise meet their minimum standards - thus providing small and minority contractors with contracting opportunities for which they would not otherwise qualify.

The SBA Office of Surety Guarantees (OSG) administers the SBG program as a partnership between the federal government and the surety industry. The SBG program consists of the Prior Approval program (Plan A) and the Preferred Surety Bond (PSB or Plan B) program. Currently, 23 surety companies —most of which have offices throughout the country—participate in the SBG program.

ELIGIBILITY

For a contractor to be eligible for the SBG Program:

- The contract must be \$2 million or less;
- The contractor's business must be independently owned and operated and qualify as a small business under federal regulations;
- The contractor's average annual receipts (including affiliates) for the last three fiscal years cannot exceed \$5 million; and



An established relationship with a surety company and producer can help a small contractor grow.

- The contractor must possess good character and reputation and must not presently be debarred, suspended, proposed for debarment, declared ineligible, or voluntarily excluded from transactions with any federal department or agency.

The program includes most contract performance and payment bonds, as well as ancillary bonds incidental to the contract and essential for its performance. This includes maintenance bonds, provided the term does not exceed two years.

THE PRIOR APPROVAL PROGRAM (PLAN A)

Under the Prior Approval program (Plan A), the SBA must individually approve each bond guarantee based on the information submitted by the surety. Plan A is intended for emerging contractors. The SBA guarantees 90% of losses incurred on bonds if the contract is \$100,000 or less, *or* if it is awarded to a socially and economically disadvantaged or Historically Underutilized Business (HUB) Zone firm. For all other contracts under Plan A, the SBA’s guarantee is 80%. Only those surety companies that are certified by the U.S. Treasury Department to issue bonds may apply for participation.

PREFERRED SURETY BOND (PSB OR PLAN B) PROGRAM

The SBA Preferred Surety Bond (PSB or Plan B) program allows SBA guaranteed surety bonds to be issued without SBA prior approval. This gives the surety the authority to issue, monitor, and service bonds. Under this program, the SBA guarantees up to 70% of the losses incurred on the bonds.

The PSB program was designed to encourage larger surety companies to help small contractors obtain surety bonds. PSB surety companies serve more experienced contractors who have demonstrated the potential for growth. Contractors are expected to graduate from the PSB program in three years.

PROVISIONS OF THE SBG PROGRAM

Participating sureties:

- Must be on the U.S. Treasury List of acceptable sureties;
- Must have an approved underwriting authority of at least \$2 million;
- Cannot have premium income from contract bonds guaranteed by government agencies exceeding one-quarter of its total contract bond premium;
- Must undergo an extensive review by the SBA;
- Cannot delegate any of its authority outside of its own employees; and
- If participating in the PSB program, cannot participate in the Prior Approval program and vice versa.



The PSB program was designed to encourage larger surety companies to help small contractors obtain surety bonds.

The provisions in the PSB program and the Prior Approval program are very similar. Surety underwriting is based on evaluating a contractor's capacity to perform and financial strength. The SBG program does, however, allow participating sureties to consider accounts where either capacity or capital may be below the company's normal underwriting standards. This often occurs when a surety attempts to underwrite a small emerging contractor.

Sureties often see contractors who are just starting their own business. The contractor may not have the capital to purchase equipment and meet the capital requirements necessary for standard surety underwriting. The surety must continue to apply the underwriting guidelines, standards, and qualifications for a standard case, but the SBA guarantee provides additional financial strength to support the contractor's limited capital position or experience.

HOW TO APPLY

Contractors should contact a surety bond producer to apply. The producer must represent a surety company that participates in the SBG program. For a list of producers located in your area who currently participate or have formerly participated in SBA's bond guarantee programs, contact a local SBA district office. For a list of names and telephone numbers of surety companies who are active in SBA's bond guarantee programs, contact the SBA's Office of Surety Guarantees central office. These offices are listed on the SBA's Web site, www.sba.gov/OSG, or call (202) 205-6540.

Contractors must complete the following forms, which are available from participating surety bond producers or SBA district offices:

- **912—Statement of Personal History**
Must be completed on first application and once every two calendar years thereafter by a proprietor; each partner in a partnership; each officer, director, and/or holder of 20% or more voting stock in a corporation; and any other person who has authority to speak for management.
- **1624—Certification Regarding Debarment**
Certifies the contractor is not personally debarred, suspended, proposed for debarment, declared ineligible, or voluntarily excluded from transactions with any federal agency.
- **1261—Statement of Laws and Executive Orders**
Contains brief summaries of various federal laws and executive orders that affect the SBA's business, and gives applicants notices of these laws.



For a list of producers located in your area who currently participate or have formerly participated in SBA's bond guarantee programs, contact a local SBA district office. For a list of names and telephone numbers of surety companies who are active in SBA's bond guarantee programs, contact the SBA's Office of Surety Guarantees central office. These offices are listed on the SBA's Web site, www.sba.gov/OSG, or call (202) 205-6540.

- **994—Application for Surety Bond Guarantee Assistance**
Contains specific questions relating to the contractor's business size, type, ability to obtain bonding, minority status, and relationship to the SBA.
- **994F—Schedule of Uncompleted Work**
Lists all uncompleted work, both bonded and non-bonded. Other forms may be used if they provide the same information. Additionally the contractor must certify the bond is required and not obtainable on reasonable terms without SBA guarantee. The amount of work sub-contracted must not be excessive so as to interpret the contractor as primarily a broker or packager. The bond amount may not be in excess of the contract amount and the work should not have started.
- **991—Guarantee Agreement Addendum**
Necessary only if the bond is issued after work has begun on the contract. SBA defines work in progress on the job as having begun when a contractor takes any action at the job site that exposes its surety to liability under applicable laws. Such actions include the purchase and/or delivery of material or actual construction.

Once the forms are completed, the surety bond producer submits them to the surety company, which processes and underwrites the application in the same manner as any other contract bond application. When the bond is issued, the contractor pays the premium for the bond, which is usually a small percentage of the contract price. The premium cannot exceed the level approved by the appropriate state regulatory body. There is no charge for applying for a bond.

The SBG program opens new markets to small and emerging contractors. The ability to obtain bonds and the development of a bonding relationship with a professional surety bond producer and surety company can help a contractor grow. Once in the program, the contractor can learn how to qualify for standard underwriting and benefit from the expert advice and assistance the surety bond producer and surety company can offer.

For more information on the SBA programs, please visit SBA's Web site at www.sba.gov/OSG/ or call (202) 205-6540.

Additional information on contract surety bonds is available from the Surety Information Office Web site at www.sio.org or call (202) 686-7463.

About the Author: John L. Hannum is Executive Vice President for the Insurance Company of the West (San Diego, CA). Barbara Brannan, of the SBA Office of Surety Guarantees (Washington, DC), provided technical assistance.

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Washington, DC 20036
(202) 463-0600
Fax: (202) 463-0606
www.surety.org
information@surety.org

SAA is a voluntary, non-profit, unincorporated association of companies engaged in the business of suretyship. It presently has approximately 600 member surety companies, which collectively underwrite the overwhelming majority of surety and fidelity bonds in the US, and 7 foreign affiliates. SAA is licensed as a rating or advisory organization in all states, DC, and Puerto Rico, and has been designated by all state insurance departments except Texas as a statistical agent for the reporting of fidelity and surety experience.



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