For the Client

A Basic Guide to Surety Bonds

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Design professionals often are asked by an owner/client to assist in obtaining the services of a contractor to construct projects either through a public bidding process or by invitation. Typically, owners wish to know how they can protect themselves in the event that a selected contractor fails to satisfy the requirements for entering into the contract or does not construct the project in accordance with the plans and specifications. In general, the answer is to use bonds issued by a surety.

Sureties are a specialized segment of the insurance industry, with their own set of procedures for performing their specific role. Sureties write bonds that are three-party agreements between the surety, the project owner, and the contractor on the project.

Although there are different types of bonds, each of which is written to guarantee certain contractual obligations, they all serve to guarantee the contractor's duties to the owner—provided the owner fulfills its obligations to the contractor. The most common forms of bonds used in the construction industry are bid bonds, performance bonds, payment bonds, maintenance bonds, supply bonds, and subcontractor bonds.

Bid Bonds

Contractors who submit bids usually are asked to provide a bid bond. The bid bond states that the contractor will enter into a contract when one is offered and will provide bonding as required. Bid bonds generally are written with a penalty equal to a percentage of the contract price; usually 5%, 10%, or 20%. They may also be written with a specific dollar penalty. If an owner offers a contract to a selected contractor and the contractor refuses to enter into the contract, the owner may make a claim against the bid bond for the difference between the price of the contract in question and the price of a substitute contract or the penalty of the bid bond, whichever is less.

Although most surety companies file rates or fees for bid bonds, it is unusual for a surety to require payment for issuing a bid bond, particularly for customers who produce bid bonds on a regular basis.

Performance Bonds

Performance bonds guarantee to the owner that the contractor will perform its contractual obligations in accordance with the plans and specifications. These bonds can take a variety of forms, ranging from the very simple to the long and complicated. There also are industry standard forms that are promulgated by such groups as the Engineers Joint Contract Documents Committee, American Institute of Architects, Associated General Contractors of America, and Design-Build Institute.

Whatever language is used, the underlying assumption is that the owner will perform its obliga-

tions to the contractor and, therefore, the surety is obligated to fulfill the duties of the contractor, if that contractor is unable to do so.

The cost of a performance bond usually is less than 1% of the contract price; however, if the contract is under \$1 million, the premium may run between 1% and 2%. Bonds may be more costly, depending upon the credit-worthiness of the contractor.

Labor and Material Payment Bonds

Labor and material payment bonds are companions to the performance bond. They assure the owner that the labor, material, and subcontractor costs on the job will be paid. This assurance is for the use and benefit of all laborers, material suppliers, and subcontractors who are eligible by contract or statute for the protection afforded by the payment bonds. They can also act as a way to protect the project from liens.

Because a performance bond nearly always is accompanied by labor and material payment bonds, they typically are included in the performance bond fee

Maintenance Bonds

Maintenance bonds are used when an owner wants a warranty period beyond one year. A warranty period can be extended for an annual fee, but sureties generally do not go beyond a total of two or three years. The annual fee for a maintenance bond is a fraction of the cost of a performance bond.

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For the Client

Supply Bonds

Supply bonds guarantee that ordered materials will be delivered. Such bonds generally are employed if an item is critical, time-sensitive, hard to find, or proprietary. Supply bonds may guarantee only a purchase order, so the terms and conditions of that order should always be carefully drafted. The cost of these bonds is usually minimal.

Subcontractor Bonds

Frequently, general contractors will require from their subcontractors the same types of bonds required by the owner. Generals may do this, for example, when the sub trade is critical to the project, the sub's price was much lower than its competitors, the sub is not well-known to the general, or the general's surety requires the bonding of some or all subs as a precondition to bonding the general.

The bottom line is that the surety industry can go a long way to removing much of the risk to bidder selection, of the project not being completed, or that the contractor's unpaid creditors will place a lien on the project. Moreover, by reducing those risks, the owner may also reduce the cost of borrowing money to finance the project.

