

# What Small and Emerging Contractors Need to Know

## Understanding the Basics of Contract Surety Bonds



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# What is a Surety Bond?

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- A surety bond is a promise to be liable for the debt, default, or failure of another.
- A surety bond is a three-party contract by which one party (surety) guarantees the performance of a second party (principal) to a third party (obligee).
  - The surety is a company licensed to provide surety bonds to third parties guaranteeing the performance of a principal.
  - The principal is the person or entity (in construction the contractor or subcontractor) on whose behalf the bond is given. It is the principal's obligation that the surety guarantees.
  - The obligee is the individual or entity with whom the principal has a contract and to whom the bond is given. In construction this is the project owner or the prime contractor.

# Surety Bonds Are Unlike Traditional Insurance Policies

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- Surety bonds are almost always written by insurance companies that are licensed by state insurance departments, but they are not like typical insurance policies.
- Surety bonds are three-party agreements, and traditional insurance policies are two-party agreements.
- The surety does not “assume” the primary obligation but is secondarily liable, if the principal defaults on its bonded obligation.
- A surety does not expect to suffer losses because the surety expects the bonded contractor to perform its contractual obligations AND the surety has a signed indemnity agreement from the contractor to protect it from any losses it suffers as a result of having issued the bonds.

# The General Agreement of Indemnity (GIA)

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- The GIA is a contract between the surety company and the contractor that obligates the named indemnitors to protect the surety from any loss it suffers as result of having issued bonds on behalf of the contractor.
- If the bonded contractor fails to fulfill its bonded obligation on a project and the surety suffers any loss, the indemnitors are legally bound to indemnify the surety for its losses.
- A surety typically requires that its principal, the individuals who control the company and their spouses, and often affiliate companies execute the GIA.
- For more information on GIAs, please see the presentation “Understanding General Agreements of Indemnity” at [suretylearn.org](http://suretylearn.org).

# The Three Main Types of Contract Surety Bonds

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- Bonds written by a surety company for construction projects are referred to as contract surety bonds.
- The three main types of contract surety bonds are: bid bonds, performance bonds, and labor and material payment bonds.
- The two basic functions of these bonds are:
  - Prequalification--assurance that the bonded contractor is qualified to perform the contracted obligation
  - Financial protection if the contractor defaults on its obligation--guarantee that the contract will be performed and certain laborers and suppliers will be paid for work and materials

# Bid Bonds

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- A bid bond from a surety company is provided as an instrument of prequalification.
- The bid bond helps screen out unqualified bidders and is necessary to the process of competitive bidding.
- Prequalification means that the surety has investigated the contractor and determined that the contractor has the ability to carry out the work under the construction contract.
- A bid bond provides the owner a means to recover the cost of having to repeat the bidding process if the awarded bidder is unable or unwilling to perform.

# Performance Bonds

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- A performance bond provides an obligee with a guarantee that, in the event of a contractor's default, the surety can be called upon to meet its obligations under the bond.
- Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.
- If the bonded contractor fails to perform its work in accordance with the plans and specifications, the owner, which has performed its contractual obligations, has a right of action against the surety to obtain completion of the contract and enforce the owner's rights under the contract.

# Payment Bonds

- A payment bond provides security for payment for labor and materials incorporated into the project by certain laborers, subcontractors, and suppliers, if the bonded principal fails to pay for labor and materials supplied for the project.
- Typically, a laborer or supplier that has a right to make a claim against payment bond is referred to as a “claimant.”
- Who is a proper claimant under a payment bond is typically restricted or limited by statute, the contract, or the bond.
- Most payment bonds require a claimant that does not have a contract with the principal to give the principal or surety, or both, written notice of its claim within a short period of time after furnishing the labor or materials for which the claim is made.
- It is critical to meet these notice deadlines, in the bond and any statutes governing the bond, or the claimant will lose its rights under the bond.

# Surety Prequalification of a Contractor or Subcontractor

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- Contractor prequalification, as performed by surety underwriters, involves a thorough and continuing process for reviewing and evaluating balance sheets, work-in-progress schedules, and financial statements.
- Surety underwriters will also evaluate factors such as the risks under the specific contract for which the contractor seeks a bond, the contractor's entire work portfolio, past performance, experience, operational efficiency, managerial skills, business plan, and integrity.
- Obtaining bonds is more like obtaining bank credit than purchasing insurance.

# Who Requires Contract Bonds for Projects?

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- Contract bonds can be required by the federal government, state governments, local governments, private owners, and general contractors.
- The federal Miller Act mandates that federal construction contracts over a certain amount require a performance bond and a payment bond.
- Each state has a “Little Miller Act,” similar to the federal Miller Act, which requires a performance bond and payment bond for state contracts over a certain amount.
- Many local jurisdictions have their own public works performance and payment bond requirements.

# Who Requires Contract Bonds for Projects? (cont.)

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- In the private sector, there is no mandate for the use of bonds on construction contracts.
- But private owners often require contract surety bonds for the same reasons the government does: to ensure that the contractor is qualified to perform the contract and that the project will be completed in accordance with the contract documents and that certain laborers and suppliers will be paid.
- Prime contractors often require their subcontractors to obtain performance and payment bonds for the same reasons.
- Sometimes lenders require owners to obtain bonds on projects as a condition for receiving financing.

# Importance of Professional Service Providers to Contractors Seeking Bonds

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- Surety bond producers assist contractors in positioning themselves to obtain surety credit, among many other services.
- Construction-oriented certified public accountants (CPAs) provide many services for contractors, including preparation of financial statements, which sureties analyze in determining whether to issue surety credit.
- Knowledgeable construction/surety attorneys advise contractors about contracts and bond forms, to help minimize and manage risks.
- Small business bankers for construction firms advise their clients on services such as lines of credit, loans, and working capital.

# suretylearn.org

provides valuable resources and information on growing your small construction business and on positioning your business to qualify for surety credit.



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