

July 2006, Volume 2, Issue 4

State & Local Contracts – Understanding Surety Bond Requirements

In order to succeed in any given business environment, contractors must be uniquely aware of the peculiarities of a given market. The State & Local Government marketplace is no exception to this rule. Within the State & Local Government marketplace, contractors are likely to encounter a contractual requirement that they do not often face in the private marketplace: a surety requirement.

Unlike customers within the private marketplace, many states and local governments are required by local codes/ordinances to require bid and performance guarantees in the form of surety bonds. In order to best understand how to meet these various surety requirements, contractors should become well versed in the language of surety bonding and fully understand why bonds are required and how sureties underwrite surety bonds.

A surety bond is a three party agreement between:

1. Obligee
2. Principal
3. Surety

In exchange for a fee and a 'hold-harmless'/indemnity agreement from the Principal to the Surety, the Surety agrees that, in the event of a default on the part of the Principal, the Surety is required to perform the terms of the contract between the Principal and Obligee. Each party to this three party agreement has unique roles, rights, and responsibilities.

Obligee – The Obligee is the entity protected by the Surety bond against loss. The surety bond 'runs to' the Obligee and the Obligee has the ability to set the language of the surety bond.

Principal – The Principal is the entity obligated, with the Surety, to the Obligee. The Principal pays the fee for the bond and, via the indemnity agreement, holds the Surety harmless for its failure to perform the terms of the contract.

Surety – The Surety is the entity obligated, with the Principal, to the Obligee. Generally*, the Surety is an unsecured creditor relying only upon the 'promise to be made whole' contained in the indemnity agreement. (**Surety does have a security interest in receivables and equipment on bonded jobs.*)

The most common surety requirements faced by contractors operating within the State & Local Government Marketplace are bid, performance, and payment bond requirements.

Bid Bond – A surety bond given by a bidder on a contract; it guarantees that the bidder, should they be selected, will enter into the contract and furnish the prescribed performance bond. The bid bond is usually a small percentage of the overall contract.

Performance Bond – A surety bond which guarantees faithful performance of the terms of a written contract. Performance Bond amounts can vary from 100% of contract price to a smaller percentage of the contract price. (Performance bonds frequently incorporate Labor and Material and Maintenance liability.)

Payment/Labor and Material Bond – A surety bond given by a contractor to guarantee payment for the labor and material used in the work which he is obligated to perform under the contract

As mentioned above, Obligees within the State & Local market are frequently required by law to require surety bonds from contractors bidding on public work. From the Obligee's standpoint, the benefits of requiring surety bonds are numerous. For example, through the requirement of a bid bond, the Obligee ensures that only qualified bidders will bid the job and, if a low bidder 'walks away' from their bid and does not enter into a contract with the Obligee, the Obligee recovers the bid penalty that will cover the costs of rebidding the job. The second benefit enjoyed by the Obligee through the surety requirements is that of prequalification. By requiring bid and performance bonds, the Obligee 'pushes off' to the Surety industry, the necessary prequalification work that must be undertaken to ensure that a given contractor has the capacity to perform the given task. In this example, the surety requirements are like 'hurdles' put in place by the Obligee; only those contractors able to clear the 'hurdles' are deemed capable to work for the Obligee. Lastly, and perhaps most importantly, through requiring a Performance Bond, the Obligee protects the public from the downside risk of contractor failure. Should a bonded contractor fail to perform the terms of the bonded contract, the Surety is required to perform on behalf of the defaulted Principal. Therefore, the public funds are protected and the project is guaranteed to be completed as contracted.

When underwriting a given contractor, the Surety will examine the contractor's character, capacity, and capital. (This is commonly referred to as the three C's of surety underwriting.)

Character – Does the contractor have a good reputation as an upstanding business?

Capacity – Does the contractor have the capacity to perform the contract? Have they done this work before? Have they successfully handled a job of similar size?

Capital – Should the contractor default, is there sufficient capital (\$\$\$) within the company to make the surety whole for the costs they will incur to remedy the contractor's default.

Insurance policies are underwritten with the expectation that losses will occur and the premium charged for the policy contains a provision for expected losses. Unlike insurance underwriting, the surety underwrites to a zero loss ratio. If the surety underwriter cannot become satisfied with the contractor's character, capacity or capital, he/she will simply decline to offer surety credit.

In order to establish a bond line with a surety market, contractors should work with an experienced surety agent that will assist them in demonstrating to the surety markets that the contractor has the aforementioned 3 C's required to gain the surety's approval. Basic underwriting information required includes several years of CPA prepared financial statements, background materials on the contractor, as well as scope of work/rfp's for the bonded job(s) in question.

The contractors that view their surety as an important member of their 'team' will enjoy more success and bond approvals than those that treat the surety as an outsider or a 'necessary evil' within the State & Local Government marketplace. Not only will the surety be more responsive to their needs and requests, however, the contractor can and should use a strong surety relationship as a competitive advantage over their competitors that may not be as readily 'bondable'.

This article has been provided by Tim Hutton (thutton@ehtins.com), Director of Surety, for AH&T. AH&T Insurance is an insurance brokerage, risk management, employee benefits, surety bond and 401(k) professional services organization dedicated to providing innovative solutions globally for businesses and individuals. AH&T is one of the largest independent insurance brokerage firms in the nation and a partner of the RiskProNet and TechAssure global broker networks. AH&T Insurance is a charter member of the Northern Virginia Technology Council (NVTC) and in 1998 was selected to design and manage insurance programs for NVTC member programs. These specially designed programs, RiskNet and BeneNet are offered exclusively to NVTC Members. For more information about AH&T, visit www.ahtins.com or call (800) 648-4807.