

## SURETY BONDS

### PROTECTION FOR THE OWNER BEFORE THE WORK STARTS<sup>1</sup>

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Property owners and asset managers need to be familiar with surety bonds, how to use them and the process of obtaining them. Those who are familiar with them and how they work know how useful surety bonds can be in *reducing* risk and keeping owner control over a work of improvement. Those who are not familiar with them, however, are missing a great opportunity *before the work even starts* to protect themselves, their company and their shareholders from the tremendous costs involved when a contractor fails to meet its contractual obligations.

Unlike insurance policies, surety bonds create legal relationships before the work commences and these relationships remain viable throughout the construction process. The relationships established by a surety bond protect the property owner (and the property owner's project) in a manner that is far different from insurance protection. Whereas insurance provides protection from casualty loss and property damage, surety bonds provide protection to assure project completion and a guarantee that laborers, suppliers and subcontractors to the project will be paid, thereby relieving owners from the risk of financial loss arising from liens filed when these same parties are left unpaid by the contractor. This "protection of the property" provides a smooth transition from construction to permanent financing by eliminating liens on private projects. And, because surety companies will typically only bond contractors who are experienced, who are creditworthy, who have the ability to obtain the necessary equipment and personnel to do the work, and who have sufficient financial strength to collateralize the bond, a contractor that qualifies for a bond (irrespective of whether it is required or not) is an important

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<sup>1</sup> The author acknowledges that much of the information for this article comes from the Surety Information Office, *The Importance of Surety Bonds in Construction*, and *Surety Bond Basics*, copyright 1996 by Federal Publications, Incorporated, written by Messrs. Dan Donahue and George Thomas of Fireman's Fund Insurance Company.

gauge for the owner to look to in order to assure itself that a qualified contractor is working on the project.

Since the first of the year, surety bonds have taken on a new and important role to property owners and asset managers. California passed new legislation<sup>2</sup> this year that turns the table on identifying the creditworthiness of the contractor and requires owners to show their creditworthiness to contractors. This new legislation requires owners of real property who contract for a work of improvement where the contract exceeds \$5 million, and certain holders of lesser property interests, such as tenants or subtenants, who contract for a work of improvement where the contract exceeds \$1 million, to provide financial security to the contractor, i.e., to post a bond or other security that they will guarantee payment to the contractor in the event of owner failure. This *reversal of creditworthiness* roles will provide even more reason for owners and asset managers to understand surety bonds and it will open the door for property owners and asset managers to become more creative in using surety bonds to protect their interests and, now, to meet *their* statutory financial security obligations.

### **SURETY BOND FUNDAMENTALS**

Let's explore the fundamentals of a surety bond. A good starting place is to describe what it is not. A surety bond is not an insurance policy. And it is not generally issued by a commercial liability insurer. It is also not a letter of credit. And it is not normally issued by a bank. Rather, surety bonds are *guarantee* agreements. Surety bonds are usually issued by corporate sureties. The surety bond "guarantee" is made by the corporate or other surety to an "obligee" that the "principal" identified in the bond will perform an "obligation" stated in the bond.

In the typical construction or tenant improvement situation, the corporate surety will

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<sup>2</sup> California *Civil Code* Section 3110.5 (effective January 1, 2002) requires owners of fee simple interests who contract for a work of improvement where the value of the work exceeds \$5 million, and owners of less than fee simple interest who contract for a work of improvement where the value exceeds \$1 million, to provide financial security to the contractor.

guarantee to the project owner that the contractor will perform the scope of work set forth in a construction contract. Surety bonds normally provide that if the principal (in this instance, the contractor) fully performs the obligation, then the bond is void, otherwise the bond remains in full force and effect and subject to the project owner's claim that the contractor has defaulted on their bonded obligation.<sup>3</sup> If the principal fails to perform the obligation stated in the bond, both the principal and the surety are liable on the bond to the obligee (in this case, the project owner) and the contractor and surety are "jointly and severally" liable to fulfill the obligation owed to the project owner under the bond, ( i.e., the project owner can sue either one or both of them and the entire liability can be collected from one or the other). Since the corporate surety is a financially sound captive to the obligation, the project owner is protected from a financial disaster brought on by the contractor's failure to perform. Without a surety bond, the project owner would have to financially rescue itself with its own funds at the expense of further job completion and jeopardy to its balance sheet and financial statements.

Thus, surety bonds provide financial security and construction assurance by assuring project owners that contractors will perform the work they contracted to perform and will pay their laborers, subcontractors, and material suppliers for the work they perform. In essence, the surety bond works as a *risk transfer* mechanism where the surety company guarantees to the project owner that the contractor will perform the work of the contract and its payment obligations to those who perform the work and supply the materials. With a surety bond, the risks of failure of project completion and payment from the contractor to its subcontractors and suppliers are shifted or *transferred* from the owner to the surety company.

Since the late 1890's, the U.S. Government has required contractors on federal public works of improvement to obtain surety bonds to guarantee their performance of the work and their payments to subcontractors and material suppliers.<sup>4</sup> This requirement has been a means of

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<sup>3</sup> Surety bonds also typically include a *private* statute of limitations that terminates the guarantee of the surety if no claim is filed in court on the bond within the time period set forth.

<sup>4</sup> The Miller Act (40 U.S.C. Section 270a et seq.) requires contractors to obtain performance

protecting the government and taxpayer dollars from contractor failure. Similarly, project owners for private works of improvement can take advantage of the same protection for the benefit of their projects, shareholders, investors, lenders, and principals.

### **THE TYPES OF SURETY BONDS**

There are different types of surety bonds. The three most common are bid bonds, performance bonds, and payment bonds. Only the latter two will be discussed here.

In the earlier paragraphs we described surety bonds that guarantee to the project owner that the contractor will *perform* its scope of work and will make *payment* to its subcontractors. In the new legislation affecting project owners of significant works of improvement, we described how the statute requires the contracting owner to provide security for the contracting owner's *payment* obligations to the contractor under the construction contract. The surety bonds that satisfy these requirements are called *performance* bonds and *payment* bonds.

A *performance bond* protects the project owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions, including meeting the price of the contract and keeping the schedule of time for performance. If the contractor defaults in performance, the project owner may call upon the surety to perform and complete the contract. In this case, surety bonds typically provide the surety with three options: (1) completing the contract itself through its own contractor, (2) selecting and paying for a new contractor to contract directly with the owner, or (3) allowing the owner to complete the work with the surety paying the costs. In any of these three scenarios, the surety is liable for the completion work up to the "penal sum" of the bond, which is usually the prime contract sum plus any change orders.

A *payment bond* guarantees that the contractor will pay certain subcontractors, laborers, and material suppliers on the project. Additionally, to satisfy its new security obligations under *Civil Code* section 3110.5, an owner can secure a payment bond for the benefit of all claimants:

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and payment bonds for all public work contracts in excess of \$100,000. Virtually every state in the United States has similarly enacted legislation requiring surety bonds on public works projects, too.

contractors, subcontractors, laborers, material suppliers, and equipment renters alike.

In the first instance, the owner receives protection from the contractor's failure and the subcontractors, laborers and material suppliers are the "beneficiaries" of the payment bond. The owner benefits indirectly from a payment bond in that the bond assures such subcontractors, laborers, and material suppliers that they will get paid on the job if they continue their performance. If the contractor fails to pay them the money that the owner has paid the contractor, they may collect from the contractor or the surety up to the penal sum of the payment bond. The penal sum on a payment bond is usually less than the total amount of the prime contract since it is meant to cover just anticipated costs to the subcontractors, laborers, and suppliers.

In the latter instance, under *Civil Code* section 3110.5, the contractor receives protection from the owner's failure and the subcontractors, laborers and material suppliers are once again the "beneficiaries" of the payment bond. The contractor benefits, too, because the payment bond assures the contractor that it will get paid for the work that it has performed, and that its subcontractors, laborers, and material suppliers will be paid.

#### **CONTRACTOR FAILURE IS RISKY AND EXPENSIVE BUSINESS**

Contractor failure can be disastrous to the project owner's bottom line. Contractor failure can take many different forms — abandonment of the work, embezzlement, untimely performance, failure to complete the work, and failure to pay subcontractors and material suppliers for their work and materials. The Surety Information Office (SIO) maintains that "[c]onstruction is a very risky business." Citing a Dun & Bradstreet report entitled *Business Failure Record*, the SIO reports that an average of 10,000 contractors fail each year!<sup>5</sup> In their wake is a trail of unfinished construction projects and unpaid workers, subcontractors, and

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<sup>5</sup> Interestingly, the SIO reports that contrary to what might otherwise be expected the age of a business is not a good indicator of ability to perform. The following percentages are attributable to construction failures by age of business: 5 years or less (32%); 6 - 10 years (29%); and over 10 years (39%).

material suppliers. With every contractor failure there is the risk of abandoned and delayed projects, increased financing costs, capital calls, lender inquiries, lost tenants, litigation and litigation costs, clouded property titles and foreclosures. Surety bonds can take away the risk of these problems. The bonds offer assurance that a contractor is capable of completing the contract on time, within budget, and according to specifications. Because surety bonds can be obtained from reputable, secure financial institutions that are qualified and licensed to transact suretyship within the state of California, surety bonds provide dependable, proven, and reliable protection against contractor failure.

Whereas the use of contractor surety bonds on public work projects is typically mandatory, the use of contractor surety bonds on privately-owned construction projects is at the owner's discretion. With the recent passage of *Civil Code* section 3110.5, project owners involved in securing significant dollar value improvements for their property are required to post proof of financial wherewithal either in the form of a line of credit, assets, or a *surety bond*. To distinguish them from the contractor surety bond they can be called owner surety bonds. It is important to understand that there is a difference between contractor surety bonds and owner surety bonds as they accomplish different protections by establishing different legal relationships. Once understood, project owners and asset managers can become more creative on securing bonds and structuring projects to satisfy their own financial obligations and also receive protection against the contractor's failure. And, while surety bonds do add a cost to completing a project, these costs are relatively minor when weighed either against an owner failure to meet its statutory bonding obligation or against a contractor failure and expenses associated with lost time, lost rent, and litigation.

#### **SECURING A SURETY BOND**

The typical cost of a performance bond is a one-time premium of 0.5% to 2% of the construction contract amount. This can vary depending on the size of the project and the contractor's bonding capacity. The better the contractor's bonding capacity (and the more dependable the contractor) the less the premium charged. Payment bonds will typically be

issued at no extra charge when issued in conjunction with a performance bond. Otherwise, again the bonding capacity, the dependability, and the credit history of the contractor will dictate the amount of the premium.

Whether the owner is securing a bond for itself to meet its obligations or is requiring a contractor to secure a bond, the owner will want to make sure that the surety is capable of responding to the failure. The best means for identifying a responsible surety is to look at the list of corporate sureties approved by the Department of the Treasury to issue bonds for federal projects. The Department identifies approved corporate sureties in Treasury Department Circular 570. In approving corporate sureties, the Department of the Treasury makes a determination of the financial strength of the surety, and it also sets a “bonding limit” or underwriting limit for the surety. Accordingly, a good place for the private project owner to shop for a surety is at Treasury Department Circular 570.<sup>6</sup>

#### **CONCLUSION AND CONSIDERATIONS**

In conclusion, surety bonds “bond” the contract and assure project completion; help assure a qualified contractor on the job; guarantee that laborers, suppliers, and subcontractors will be paid; relieve the project owner from the risk of financial loss arising from mechanic’s liens filed by unpaid laborers, suppliers, and subcontractors; provide an intermediary to whom the owner can complain; and otherwise screen out unqualified contractors and irresponsible bids. Performance bonds plainly protect the owner from contractor default and delays, which helps commercial property owners keep fixed tenant availability dates. Payment bonds protect against mechanic’s liens filed against the property, which otherwise will interfere with sale or refinancing of the property. Property owners and asset managers need to be careful that their contract language matches their bonding expectations and obligations. Also, project owners need to be aware of the new statutory requirements of providing security for their payment to contractors. While AIA form contracts contain language regarding bonds, they don’t address securing bonds before the construction starts and they don’t address how the bond language and responsibilities will or can be coordinated with the construction contract language. Finally, the AIA forms do not address the project owners’s statutory duty to provide security for the contractor under *Civil Code* section 3110.5. As discussed here, a surety bond may be just the answer for protecting the property and satisfying the requirement.

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<sup>6</sup> Copies of the circular can be obtained directly from the Treasury Department and the circular is posted on the Treasury’s Web site at [www.fms.treas.gov/c570](http://www.fms.treas.gov/c570). The circular lists the name and address of each approved surety and all states where each surety is licensed.