

Foundations of Contract Bond Suretyship

BENEFITS OF CONTRACT BONDS

Contract suretyship—in the form of bid, performance, and payment bonds—provides specific benefits to project owners, contractors, and several other parties.

A **surety bond** is a written agreement under which one party, called the **surety**, obligates itself to a second party, called the **obligee**, to answer for the default of a third party, called the **principal** or obligor. **Suretyship** is an obligation to pay the debts of, or answer for the default or miscarriage of, another.

A **contract bond** is a surety bond given to secure the performance on a construction contract. Frequently, two bonds are required: one to cover performance (performance bond) and another to cover payment of certain labor and material bills (payment bond).¹ Most contract bonds are written on public work, which includes federal, state, and local projects.

Benefits to Project Owners

Project owners benefit from surety bonds in several ways. **Bid bonds** provide financial assurance that the contractor submitting a bid, if awarded the construction contract, will enter into a formal contract with the owner and will post performance and payment bonds. Performance bonds guarantee that the contractor will fulfill all terms, specifications, and conditions of the construction contract. The payment bond guarantees that the contractor will pay labor and material bills associated with the contract. The surety's full capital and surplus back guarantees up to a bond's financial limit, also called the bond penalty. Thus, the construction-project owner receives significant financial assurance beyond the contractor's financial resources.

Surety bonds also give the owner the additional security of knowing that the contractor has satisfied the surety's comprehensive prequalification review. Finally, owners might receive the indirect benefit of lower prices from subcontractors and suppliers who, in the absence of payment bonds, might be inclined to charge higher prices to compensate for their credit risks.

Lenders are more confident in extending project financing in the form of construction loans when they know that the construction risk has a surety's guarantee. The surety guarantee eases the transition from construction to permanent financing. Many owners have benefited from increased availability

Surety bond

A written contract that expresses one party's promise to answer for another party's failure to do something as promised.

Obligee

The party to a surety bond that receives the surety's guarantee that the principal will fulfill an obligation or perform as promised.

Surety

The party (usually an insurer) to a surety bond that guarantees to the obligee that the principal will fulfill an obligation or perform as required by the underlying contract, permit, or law.

Suretyship

The obligation of one entity to answer for the debt, default, or miscarriage of performance of duties by another entity.

Principal

The party to a surety bond whose obligation or performance the surety guarantees.

Contract bond

A surety bond guaranteeing the fulfillment of obligations under construction contracts or other types of contracts.

Bid bond

A contract bond guaranteeing that a contractor bidding on a construction or supply contract will enter into the contract and will provide a performance bond if the bid is accepted.

of better financing or terms than they would have received in the absence of a surety bond.

For the architect or engineer, the bond provides confidence that, in the surety's judgment, the contractor can translate project plans into a finished product. The project owner gains the security of knowing that the bond provides protection should the contractor fail to perform. For taxpayers, the contract surety bond makes an open, competitive bidding system possible, with contracts going to the lowest responsible bidders, thus saving public funds.

Benefits to Contractors

Contractors benefit by using contract surety bonds from a prequalified corporate surety. Even if a public entity will accept alternate security for the bid process, the successful contractor is almost always required to post performance and payments bonds from a corporate surety. To be confident that the surety can meet its obligations under the bonds, the public entity may require that the surety be Treasury listed or that its A.M. Best's rating be above a specified level. Surety credit can enhance a contractor's competitive position in private work because the contractor can offer project owners and lenders the assurance that its capacity to perform has been carefully reviewed. Owners know that a surety will not commit to a bond program without carefully evaluating a contractor's qualifications. Thus, the bond serves as an objective prequalification, greatly increasing a contractor's credibility.

Construction is an inherently risky business. Every day, a contractor's experience and abilities are pitted against the rigors of unremitting competition, the weather, an uncertain economic environment, a potentially inadequate labor force, possible defects in quality or design, and a host of other factors. Every year, thousands of contracting firms fail. Surety prequalification reduces the likelihood of contractor failure, partially through a rigorous analysis of the contractor's qualifications. Only those contractors who, in the judgment of sureties, possess the necessary character and who have the resources and ability to perform their contractual obligations receive surety backing.

Benefits to Other Parties

Laborers, subcontractors, and suppliers receive financial assurance, via the payment bond, that they will receive payment for their services on the bonded project. This assurance is particularly significant for public-works projects because mechanics liens for labor and material cannot be filed against publicly owned property. See the exhibit "The Miller Act."



The Miller Act

The United States Congress passed the Heard Act in 1894, requiring contractors on public works to “execute the usual penal bond, with good and sufficient sureties, with the additional obligations that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials. . . .” In 1935, this act was replaced by the Miller Act,* which requires a separate payment bond to protect certain subcontractors’ and suppliers’ payment rights for material and labor provided for federal construction projects. The Construction Industry Payment Protection Act of 1999 (CIPP) revised the Miller Act. Before the 1999 revision, the payment bond required was not to exceed 50 percent of the contract price, subject to a maximum of \$2.5 million. CIPP revised the Miller Act to set the payment bond amount generally equal to the contract price. With that amendment, in most cases, the Miller Act requires a 100 percent performance bond and a 100 percent payment bond on federal public works of \$100,000 or more. Nearly all state, county, and municipal governments have adopted similar legislation (some of which are known as “little Miller Acts”) to protect the contractual rights of those who provide labor and material for public works projects.

* 40 U.S.C. Secs. 270a et seq.

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PROJECT DESIGN AND CONSTRUCTION PRACTICES

To understand the role of contract surety bonds in a construction project, surety professionals must be knowledgeable about the design and construction processes and a variety of construction practices and concepts.

Construction projects involve project owners, various engineers, construction managers and contractors, sureties, financial institutions, and various subcontractors, many dedicated to certain aspects of construction. The design and construction processes are facilitated by construction management, design and build methods, project financing, contractor selection, a bidding process, scheduling, and, when substantial completion is achieved, maintenance of the structure. Every construction project begins with the design process.

Design Process

The design process involves coordination of many diverse interests. Architects often act as central coordinators during the design phase. Extensive probing and questioning of the facility’s end user will determine current needs and contemplated future growth. Financial constraints affect every design decision.

The architect prepares preliminary sketches, including renderings, of the new structure. After the property owner or end user approves the preliminary sketches, the architect employs professional engineers. Professional engineers tend to restrict their practices to specialized areas, such as structural



components (civil engineers); electrical components (electrical engineers); or heating, ventilating, air conditioning, and plumbing (mechanical engineers).

Civil engineers determine the size and consistency of foundations, the need for sheet piling, the design of reinforcing bars inside concrete foundations, and similar matters. They also determine the size and characteristics of the steel or masonry walls that carry the weight of the structure.

Electrical engineers determine the voltage and amperage loads required by heating, ventilating, and air conditioning units, as well as lighting requirements. They also consider specialized electrical machinery or equipment, such as elevators, computers, or manufacturing apparatus.

Mechanical engineers deal with heating, ventilating, and air conditioning, contemplating such factors as the building's use and the type of equipment to be installed.

Here is an example of how a typical design process works:

1. The design professional interviews the client and measures current and future needs.
2. The design professional reviews existing facilities for potential renovation and for their ability to handle future growth needs.
3. Professional engineers, architects, and attorneys obtain required zoning approvals and ensure that plans and specifications comply with all government regulations.
4. For new construction, the future owner either acquires or obtains an option to acquire the land or the building to be renovated.
5. The owner acquires a building permit, which may be subject to restrictions for zoning approval, parking, sewer access, utilities, labor and industry approval, environmental impact studies, and other restrictions.
6. The owner arranges financing before construction.

Construction Management

The practice of using construction managers emerged in the 1970s and is an increasingly accepted approach today. A construction manager, typically hired during the feasibility study or the design process, uses experience with construction and prices to influence the design.

The construction manager offers alternative designs to minimize construction costs while maximizing the use of the facility. Construction managers frequently assist in preparing specifications; advertising for and reviewing bids; awarding contracts; managing construction; and approving monthly requisitions, billings, and final payments.

Construction management contracts must be carefully reviewed to determine the risks and obligations the construction manager is assuming. At one extreme, the construction manager may receive a fee simply for coordinating

