

How Surety Bonds Work

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Construction contractors are interested in satisfying [surety bond](#) requirements on the projects for which they compete as inexpensively as possible. A surety's primary objective is to identify contractors that have the ability, resources, and tenacity required to complete the construction projects they propose to build. Thus most of the process of obtaining surety bonds is devoted to information about the contractor's business. A secondary but necessary element in the process is to identify individual indemnitors who have sufficient assets to hold the surety harmless from any claims filed against the bonds.

Contractors' Interests in Selecting a Surety

Contractors have a choice in selecting surety companies. Different sureties may charge the contractor a different premium rate, resulting in savings for the contractor. In addition, one surety may be willing to issue bonds with a higher dollar limit than another, and this can result in additional work for which the contractor can compete and perform. The contractor also has an interest in finding out the financial strength and experience of the surety. If a problem develops during the project, one surety might more readily choose to work with the contractor toward resolution than would another surety, perhaps avoiding a default. Contractors thus have an interest in inquiring into these issues before selecting a surety company.

Where Bonds Are Available

A contractor can usually apply for and obtain construction surety bonds at the insurance broker it uses for business-related insurance policies. The broker probably has already obtained the necessary financial information from the contractor for casualty insurance purposes. The broker may even be the primary point of contact between the surety and the contractor.

Surety bond premiums usually are priced as a percentage of the penal sum of the bonds issued. The premium percentage rate may vary among surety companies and among different contractors. The largest, most financially secure contractors in the United States would pay the lowest bond premium. A typical contractor may pay a bond premium between one percent and five percent of the penal sum.

Surety's Evaluation of the Contractor's Business

Each surety company has different criteria for deciding which contractors it will bond. However, all sureties evaluate the contractor and the contractor's work to decide whether the surety will bond that contractor. Since the surety guarantees the contractor's performance, the surety needs to decide whether the contractor has the ability and resources to perform. Any guarantor has an interest in guaranteeing only a dependable product or service, and sureties are no different. A surety's means of evaluating a contractor to decide if it will issue bonds is the underwriting process. This process sometimes is described as evaluating the 4 C's-Character, Continuity, Capital, and Capacity.

Character of the Business and Key Personnel

A surety would like to guarantee the performance of those contractors that have shown that they are honorable, dependable businesses that can be counted on to perform. A surety is interested in how long the contractor has been in business and its reputation in the industry among owners, architects/engineers, general contractors, subcontractors, and suppliers. With a new business, a surety may look to the experience and reputation of key management personnel. Also, a surety is interested in the reputations of other key personnel.

A surety will look at the contractor's management structure and organization chart, the length of time current management has been in place, and the experience and track record of the managers. The contractor's experience in the construction industry is important, but the surety is also interested in the contractor's management skills. Basically, a surety looks for the characteristics common to any well-run business: a management team experienced in the industry, with a proven track record of success; an adequate accounting system with appropriate financial controls and reporting capabilities; and a history of stable, profitable business.

A surety would like to see a full-time CEO who is experienced in the construction industry, with an adequate staff to perform the work. Finally, a surety probably would want to see that the contractor has identified its strengths, and sticks to the types of construction projects it does best.

Continuity of the Business

A surety is interested in continuity in the management of the contractor's business. A surety prefers a written plan to continue the business upon the death or retirement of key contractor personnel. This includes a written plan of succession for management personnel, and buy-sell agreements for stock or other interests in the business. In general, a surety is interested in seeing a well-thought-out plan to continue performance of the work and the continuity of the business should key contractor personnel leave the business.

Capital in the Business

A surety is interested in the contractor's net worth, amount of uncompleted work, cash flow, accounts receivable, and accounts receivable aging information. A surety also looks at the contractor's credit history, working relationships with subcontractors and suppliers, and bank account information. A surety is interested in evaluating all of a contractor's capital assets as a way of learning the financial strength of the contractor. A surety also requires that individual indemnitors have sufficient assets to secure their promise to indemnify the surety in the event claims are made against the bond.

Capacity of the Business

A surety must decide how much work a contractor can perform profitably in order to set a bonding limit for that contractor. Such an evaluation includes subjective judgments about which different sureties may reach different decisions. The capacities of the contractor's available plant, equipment, and personnel are factors in reaching this decision. Considering these and other factors, a surety will set an upward dollar limit for a maximum individual project that it will bond, and an upward dollar limit for the total of all projects it will bond for that contractor. A surety's interest is to prevent the contractor from becoming over-extended by taking on more work than the contractor can handle.

Evaluation of the Indemnitors' Assets

A surety will not issue bonds to a contractor unless the surety has decided that the contractor can perform the contract and complete the project. However, once this determination is made, a surety will then require security for its bonds. This security is usually an agreement by individuals, indemnitors, who agree to indemnify the surety. The surety will evaluate these individuals and their net worth to figure out their financial ability to stand for any loss that the contractor causes.

Types of Acceptable Assets

Different sureties use different evaluations and have different opinions concerning the types and amounts of assets they find acceptable. Sureties prefer unencumbered tangible assets that quickly and easily may be liquidated into cash. The [FAR part 28](#) listing of assets acceptable and unacceptable to the federal government is a fairly good guide for what commercial surety companies prefer as well. Like the federal government, surety companies prefer cash, certificates of deposit or other cash equivalents, irrevocable letters of credit from acceptable financial institutions, United States government securities, stocks and bonds actively traded on U.S. National Securities Exchanges (New York Stock Exchange, American Stock Exchange, etc.), or real property owned in fee simple. Assets that a commercial surety probably would find less desirable or unacceptable would be accounts receivable, foreign securities, a principal residence that likely would be wholly or partially exempt from attachment

under a homestead exemption in most states, and life estates or future interests in real property. Generally, commercial surety companies look less favorably on assets that are of speculative value, whose value may fluctuate markedly over time, and which would be difficult to attach and liquidate.

Identification of Assets as Collateral

Once the assets offered as collateral are found acceptable, then the principal, indemnitors, and the surety may identify them in writing. The assets may be identified in a receipt of collateral form, an affidavit, or other document. The idea is to identify the assets in sufficient detail so that they could be segregated and pursued by the surety if necessary to obtain the indemnification promised by the indemnity agreement, discussed below.

Common Provisions in Indemnity Agreements

The surety will not issue bonds unless it has received agreements from the principal and other indemnitors with sufficient assets, in the surety's opinion, to secure the surety from any claims that may be made against the bonds. This is done by an indemnity agreement to be signed by the principal and the individuals who will serve as indemnitors. The agreement is a contractual obligation that provides security for the surety. The indemnity agreement sets forth and expands upon the separate common law obligations between the principal and the surety. A separate indemnity agreement may be issued for each bond. However, more frequently, the parties enter into a general indemnity agreement covering any bonds that the surety may issue to that contractor. Typical provisions in such a general indemnity agreement are explained below.

Indemnification of the Surety by the Indemnitors

The indemnitors (the contractor and individuals who have pledged their assets to support the bonds) agree that they will indemnify (completely reimburse) the surety for any liabilities, attorney's fees, expenses, or damages the surety may incur as a result of its issuance of a bond to the principal. A surety that pays the debts or obligations of its principal is entitled to indemnification by the principal even at common law. The written indemnity agreement confirms the principal's obligation and extends the obligation to all the indemnitors.

Not surprisingly, a very broad form of indemnification typically is provided to cover all types of anticipated costs. Frequently, the indemnification provision will say that it includes all damages incurred by the surety's reliance upon representations by the principal or indemnitors concerning defenses available to the surety in any claims made against the bonds. Thus if the surety asserts a defense based on representations by the indemnitors or the principals, and the defense ultimately is found to have been frivolous, the indemnitors would be required to reimburse the surety for any damages or sanctions sustained by the surety.

A surety also has the common law right against its principal to require the principal to pay any debt or liability before the surety is called upon to pay it. This is usually called the common law right of “exoneration;” the surety is exonerated from liability by the principal’s payment of the debt. An indemnity agreement contains provisions in which the other indemnitors agree to give the surety the same right to require them to pay claims against the bonds as they are made. Thus typical provisions of an indemnity agreement give the surety the right to require the indemnitors to pay claims before the surety is re-quired to do so, and to completely reimburse the surety for claims paid by the surety.

Indemnitors Agree to Deposit Collateral as Reserves

When the surety is advised of a claim or possible claim, the surety may establish a “reserve”-which is an account or fund with a sum sufficient to pay the estimated extent of the possible claim. A typical provision in an indemnity agreement states that if the surety sets up such a reserve to cover potential liability, the principal and indemnitors agree to deposit with the surety an equal amount to serve as collateral. In addition, such provisions say that assets pledged by the principal and indemnitors will be made available to the surety as collateral for such a reserve. Such provisions typically also say that the surety has the right to use such collateral to pay any and all liability it may have under its bonds.

Surety’s Authority to Take Over the Work

Another typical provision gives the surety the right, but not the obligation, to take over prosecution of the work using the principal’s plant and equipment, and to consent to changes in the contract or the work. These provisions also grant the surety the right to make loans or advances to the principal or others for purposes of completing the contract, and require the principal and indemnitors to reimburse the surety for such loans. The effect of these provisions is to authorize the surety, by taking these measures, to use its own judgment to try to avoid a default and to minimize damages due to a default.

Assignment of Contracts

The principal and indemnitors may also assign to the surety all of their rights under the contracts for which the surety issues bonds. Such provisions specify that they include all subcontracts; the principal’s rights under all subcontractors’ surety bonds; all contractual rights to plant, equipment, tools and materials; all rights to receive proceeds from contracts; and all claims and causes of action that the principal or indemnitors may have concerning a project bonded by the surety. This provides the surety the opportunity to maintain the benefits of the principal’s subcontracts in the event the principal is defaulted.

Indemnity Agreement May Be Filed as a Security Agreement

The principals and indemnitors also agree that the indemnity agreement and related receipt of collateral documents may be filed by the surety as a security agreement under the Uniform Commercial Code (UCC) to provide notice of the surety's security interest in the collateral pledged by the principal and indemnitors. The [UCC](#), adopted with slight variations in all fifty states, provides a uniform system for filing notice in property records so that creditors and others may have notice of another creditor's prior interests in these assets. The effect of this provision in an indemnity agreement is to allow the surety to protect its interests in the indemnitor's assets and to establish a position superior to subsequent creditors.

Contract Proceeds are Trust Funds for Bond Beneficiaries

Another common provision in indemnity agreements says that the funds paid to the principal under bonded contracts shall be held by the principal as trust funds for the benefit of the beneficiaries of the bonds issued by the surety. Thus payments by the owner to the prime contractor on a bonded contract would be held in trust for the benefit of subcontractors and suppliers, who are the beneficiaries of a payment bond. Often indemnity agreements also provide that the surety may require the principal to establish a separate account for contract proceeds, designated as a trust fund, and that the surety must approve all withdrawals from such an account. This allows the surety to monitor payments on the project and to see that subcontractors and suppliers receive their payments.

Surety's Right to Settle Claims Against the Bond

Another typical provision specifies that the surety has the sole and exclusive right to decide whether any claims against the bond should be paid, settled, or defended. The principal and indemnitors agree that the surety's decisions on such matters shall be final and binding on them.

Surety's Right to Examine Financial Records

An indemnity agreement usually contains provisions giving the surety the right to request financial information from the principal and indemnitors as it deems necessary. This provision will include the right to examine books, records, accounts, and other financial information as necessary. Further, such provisions often give the surety the right to request financial information from third parties, such as banks, credit reporting services, subcontractors, or suppliers.

Other Typical Provisions

A general indemnity agreement, which would cover any bonds issued by the surety, will provide that the surety retains the right to refuse to issue any bond at any time. Thus the surety has the right, but not the obligation, to issue additional bonds. Other

terms provide that the indemnitors waive receipt of notices of the execution of bonds and waive minor informalities in the execution of bonds. Indemnitors also agree to accept service of process and to voluntarily join suits that may be brought against other indemnitors.

Surety's Role During Contract Performance

Subject to certain legal exceptions, performance and payment bonds specify that the surety waives prior notice and the right to consent to changes in the work. In addition, most contracts provide that changes may be made without notice to the surety. This does not mean that the surety does not have a role during contract performance before any claims are filed.

Under some bond forms, the surety may be required to participate in meetings to resolve problems or disputes. In addition, the surety's rights under indemnity agreements, reviewed above, govern this period. For example, if the indemnity agreement provides that progress payments are to be treated by the principal as trust funds for the subcontractors and suppliers, the surety has the right to require the principal to comply. Also, the surety has the right to obtain financial information from the principal, and may receive payment and progress information and construction information during performance. The surety also has the right to advance funds to prevent a default.

Role of Principal and Surety When Claims are Filed Against the Bond

Performance Bond Claims

The obligee of a performance bond typically is the owner, but it may also be the general contractor or other superior contractor. As discussed above, the surety's obligation under a performance bond is to see that the bonded contract is completed in case of a default by the principal. The surety may learn of a possible default beforehand, by receiving complaints directly from the obligee, the principal, or even third parties. The surety also may gain information beforehand by receiving information about payment disputes that concern the payment bond (discussed below).

If the surety learns of a possible default before it happens, the surety usually requests information about the situation from its principal and others, such as the owner or other contractors working on the project. Each situation is different, and the surety's options and actions differ in each case. Some performance bond forms require the owner to give a pre- default notice to the surety, and provide for a meeting of the owner, contractor, and surety to discuss completion of the contract. The surety usually has the right, but not the obligation, to advance funds to the principal or others. If such advances are made, the principal and other indemnitors would be required to repay these advances to the surety. The surety also may notify the owner or general contractor that future payments for contract work are to be made directly

to the surety, rather than to the principal. A surety might direct payments to itself when the surety decides to advance funds for performance of the contract work.

If the surety receives notice that its principal has defaulted, the surety must decide which of its options it will choose, or if it will defend against the default. A surety has the right to defend itself by asserting all the defenses of its principal (*e.g.*, the principal was actually not in default; was prevented from performing by defective specifications; or was not given contractually required cure notices, etc.), as well as asserting any defenses the surety may have under its performance bond.

As to its options, the surety may complete the work at its own expense; or it may obtain bids from completion contractors and then arrange for them to contract directly with the owner or other obligee; or the surety may allow the obligee to arrange completion of the work with the costs to be paid by the surety. In such a situation, the surety may establish a reserve for its potential loss. The surety would have the right to demand that its principal and other indemnitors not only indemnify the surety, but also that they pay completion costs as incurred so as to exonerate the surety. If the indemnity agreement so provides, the surety could also demand that the indemnitors provide collateral from which the surety's costs would be paid.

In completing the work, the surety may have the right under the indemnity agreement to use the principal's plant, equipment, and materials, and to use existing subcontractors and suppliers whose contracts have been assigned to the surety in case of a default. The surety has the right to receive whatever payments from the owner or other obligees as are owed to the principal, and also payments earned by the surety in completing the work.

Payment Bond Claims

When a payment dispute arises, the surety may be notified of a potential claim on the bond. If the matter remains unresolved, the next step would be that the surety receives a written notice from the potential claimant saying that the claimant has not been paid, and that the claimant intends to look to the surety for payment if the principal does not pay. Usually, such notices are also sent to the owner, general contractor, and other contractors superior to the claimant.

In such a case, the surety usually asks its principal for information about the dispute. The surety will usually request information from other parties as well, such as the owner and other contractors. These inquiries are necessary because the surety is required to perform an independent investigation of the facts concerning a claim.

If the surety decides that it is appropriate in a particular case, the surety may establish a reserve to pay the potential claim. The decisions to establish a reserve and to set the amount of the reserve are complicated ones and often involve subjective decisions by the surety. If a reserve is established, the surety may require the principal or indemnitors to deposit collateral to cover the reserve, if the indemnity

agreement so provides. In addition, the surety may request additional information from the principal trying to learn more about the situation. On the other hand, the surety may allow the principal to respond to the situation, if the principal asserts defenses to the potential claim, and otherwise appears to be able to satisfy the claim.

In the event that the principal does not pay the claim, the surety has the right to either settle the claim, or to deny the claim and assert the contractual defenses of its principal (*e.g.*, the work was defective or failed to comply with specifications) and its own defenses under the bond (*e.g.*, the claim was not made within the time required in the bond). If the claimant sues the principal and the surety, the principal has the obligation to defend the surety by retaining and paying for a lawyer to defend the surety, and to pay any resulting judgment. If the principal fails to do so, the surety may retain a lawyer at the principal's expense to defend the surety.

Conclusion

Before claims arise, contractors need a basic understanding of surety bonds in order to understand their rights as they may be related to other interrelated rights of the principal, obligee, and claimants. This article is intended as an introduction to the subject. It is an effort to briefly describe these relationships so that they may be understood before claims are made and difficult decisions must be made quickly. Obtaining surety bonds is not only an important part of the construction contracting process, but it also involves substantial rights and responsibilities independent of the construction contract that often are overlooked until claims are filed. A basic understanding of the process beforehand will prevent surprises and help contractors better understand this essential part of the construction process