What You Need to Know to Understand the Surety Process

Demystifying construction contract surety bonds & protecting your projects from unforeseen circumstances

by Ken Chapman

Wednesday, October 7th, 2020

Contract surety bonds provide essential protection for key parties involved in a construction project. They secure both project performance and payment of project-related costs in the event of unforeseen circumstances. Despite this, many projects are not bonded—potentially creating significant risks for project owners, subcontractors and suppliers.

One reason surety bonds are not used more often might be the perception that securing them is a complicated, burdensome process. That is unfortunate, as the benefits far outweigh the effort necessary. In addition, construction companies could be cutting themselves out of bidding opportunities on publicly funded projects, as most require surety bonds. Construction executives serious about growing their business would be wise to invest some time in establishing a relationship with a surety provider. It does not have to be a confusing or laborious process, as detailed below.

What Is a Contract Surety?

It can be helpful to think about the surety process as a way to pre-qualify a construction company for a project. Securing a contract surety bond means a company has passed a rigorous assessment of its financial health, organizational capabilities and its ability to complete the project.

Contract surety bonds are generally provided by insurance companies specializing in this area with the product representing a three-party obligation. The insurance company is the first party, the surety, and guarantees the performance of the second party, the contractor, to a third party, the obligee, such as a developer or project owner. An important distinction here is that surety is not insurance for the contractor, it's a credit guarantee very similar to what a lending institution provides.

In most cases, if a developer (the obligee) wants to build a project, they hire a construction company (the second party). In order to ensure that the project will be completed and financial obligations to suppliers, subcontractors and others are met, the developer can ask the contractor to provide bonds. Then it is up to the construction company to go to a surety agent who works on the company's behalf to find the best surety provider to secure the bonds.

The insurer will conduct a detailed review of not only the project, but also the construction company itself (more on that below). A knowledgeable surety agent will help you navigate the process smoothly and efficiently. If everything meets their requirements, the surety company establishes a relationship with the construction company and provides the necessary bonds.

Types of Contract Bonds

The type of contract bond a contractor will have to secure depends on the project, parties involved, and the requirements of the developer or project owner. The most common are the following:

1. *Bid bonds*—These provide financial protection for a developer or project owner in cases where a contractor submits the low bid but either doesn't actually sign a contract or fails to secure payment and performance bonds. Bid bonds are also a way to ensure only qualified contractors submit bids, as a surety will not issue one to a construction company that is not capable of handling the project.
2. *Performance bonds*—Performance bonds protect developers and project owners when a contractor defaults or doesn't finish a construction project. They allow the developer to have the project completed as laid out in the contract (i.e., by hiring another contractor as one option). There are detailed terms and conditions in the contract bond outlining how this can be accomplished.
3. *Payment bonds*—Developers and project owners need to have their projects delivered free of liens. In the public sector, generally speaking there are statutes meant to protect those supplying labor or materials on a project. With a payment bond in place, these entities can make a claim with the surety and seek restitution. Having a payment bond also lessens the chance that unpaid subcontractors will stop work and cause delays or even derail a project.
4. *Warranty bonds*—These are sometimes known as maintenance bonds and ensure any defects in workmanship or materials will be taken care of during the warranty period.

Navigating the Surety Process

As noted above, a surety essentially prequalifies a contractor and guarantees that they will finish a project and pay their bills. The process for securing a surety is very similar to applying for a mortgage or business loan and your agent should help advise you through the process. It's an evaluation that reviews a contractor's financial health, operations and work history. As it conducts its assessment of the contractor, the surety will review a number of things, including:

- Areas of expertise/experience
- Balance sheet
- Banking history and relationships
- Cash flow
- Contractor's character and reputation
- Credit score and history
- Current and past projects or work
- Details of the proposed project
- Net worth
- Profit and loss statement
- Working capital

This is a thorough process, and there are things a construction company can do to ensure it happens as efficiently as possible. Mostly, it's about being organized and having all the documentation the surety company will need in order to do its work. This documentation should include:

- Complete personal and company information
- Details of any bank loan agreements, including lines of credit Information on the project to be bonded, including the contract
- Personal financial statements for company owners
- Proof of insurance
- References from suppliers, creditors and project owners
- Resumes or detailed bios for owners and key company employees
- Schedules of work for current and completed projects
- Signed indemnity agreement in which company and owners pledge their guarantees to the surety
- Three years of complete financial statements, along with the current year's interim statement

Having all of this ready and available for the surety can go a long way to keeping the review process on track. Navigating the surety process is similar to the process of applying for a loan. It doesn't have to be confusing or laborious. While securing a surety relationship can take some time and involve a bit of effort, there are many important reasons why it's crucial—the least of which is that it can open up additional project opportunities.

The surety relationship should also be seen as an important business partnership—one that can last decades in many cases and brings key benefits. Taking the time to find the right surety partner for your company is an investment in your business that will pay off.