CONSTRUCTION INDUSTRY GUIDE

The ABCs of Surety Bonds

It's assurance — *not* insurance

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Meeting surety bond requirements is an ever-present need for contractors that build in both the public and private sectors. A lot of work goes on behind the scenes to determine whether your company will qualify for surety credit.

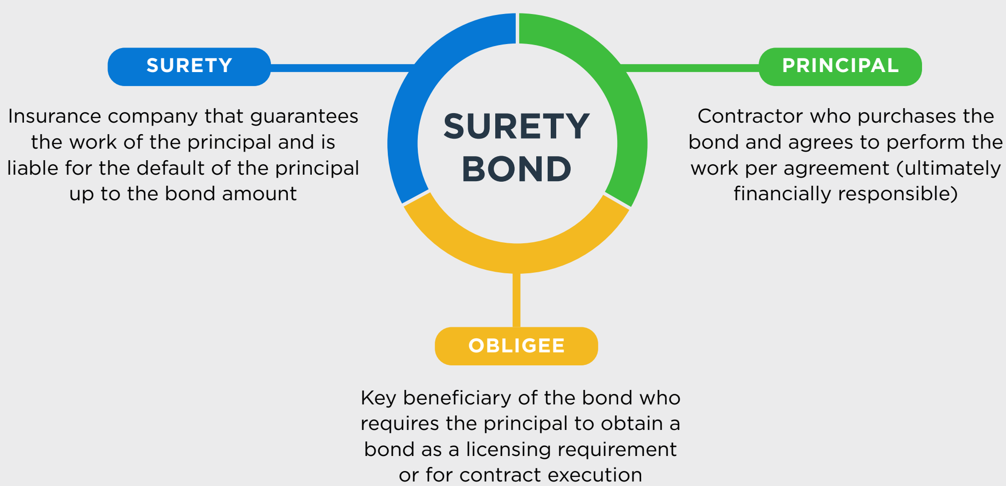
As a contractor, you are generally required to post bonds on projects to protect your owners and customers, but you can also use bonding as a risk mitigation tool to protect your business. Establishing a bonding program can provide you with the capacity to bid on larger projects, and help you grow your backlog and avoid any last-minute “fire-drills” to secure a bond.

This guide will teach you the ABCs of surety bonds and how to streamline the underwriting process while taking your business to the next level. Working with an expert can help you fully understand the requirements to qualify for bonding capacity/surety credit, improve turnaround times and provide access to a variety of surety markets that offer a wide range of solutions.

Surety: What is it?

A surety bond is a financial guarantee that a company or individual will deliver on a specific obligation. Essentially, a surety bond is a written promise, backed by an insurance company, that a person or company will perform the requirements of the contract, and if they fail, the insurance company will compensate for any losses.

A bond is like a stamp of approval, showing that a company or person has been vetted and is trusted to do their job.



Who Needs a Surety and Why?

Contractors, suppliers, subcontractors and project owners all need surety bonds to protect their businesses, owners, lenders and taxpayers, and to help minimize risk during construction projects.

Surety bonds are required by law for public construction projects in the U.S. and for many (but not all) public projects in Canada, whether they're municipal, state/provincial or federal. However, the economic value and protection surety bonds bring to projects has garnered the attention of the private sector, which is increasingly using them to mitigate the risks associated with economic uncertainty and supply chain challenges.

Banks and lenders also acknowledge the importance of sureties and are requiring these bonds more often than ever before for added protection. With rising interest rates, inflationary cost escalation and labor shortages widely impacting the construction industry, contractors themselves can require bonding on critical path items on projects to mitigate the risk of default from a subcontractor or supplier.

A recent EY survey of private construction contractors cited a number of reasons sureties were being used more often in private projects, including:[1]

- **More rigorous prequalification and review:** About 96% of respondents said that prequalification was performed for bonded projects compared with just 61% for nonbonded ones. Contractors were nearly twice as likely to share financial updates for bonded projects than nonbonded.
- **Higher priority and greater oversight:** Nearly five times as many respondents indicated that contractors placed a higher priority on bonded projects compared with nonbonded when facing financial difficulty. While contractors may place a higher priority on bonded projects to protect their indemnity package, the increased involvement by construction managers also prevents losses, respondents said.
- **On time or earlier completion:** Five times as many public and private owners said bonded projects were more likely to be finished ahead of schedule than nonbonded ones. Respondents also noted that when a project participant did default, an unbonded one took nearly twice as long to complete than bonded.
- **Increased experience and resources:** All noted that sureties have a higher level of expertise, tools and resources necessary to complete a project in "the most cost- and time-effective manner as compared to an owner who does not have the same expertise and experience as a surety."

In addition, sureties offer significant benefits for contractors, subcontractors and project owners. These include reducing the risk of project default, ensuring business continuity and providing technical and financial assistance. Surety bonds also make the transition from construction-to-permanent financing easier by eliminating liens, and they can even lower construction costs through improved bidding competition.

[1] EY QUEST Group, "The Economic Value of Surety Bonding," November 2022.

Bond Benefits

A surety bond assures your customer that you will honor the contract through the project's completion. If an unforeseen event occurs and you can't complete the project, the guarantor (surety) will step in and provide a few different options to your customer on how to proceed. Sometimes this can be as simple as a dollar amount payout, but other scenarios may require the surety to find a replacement contractor to finish the work on your behalf.

For your customer, this assurance means that once a project begins, it will be completed.

Sureties also can assist contractors in other matters, such as providing technical, managerial or financial assistance; reducing the risk of liens filed by subcontractors, laborers and suppliers; and lowering project costs. Other surety benefits include providing capable and qualified contractors, protecting taxpayers and overseeing smoother transitions from construction to permanent financing.

Types of Surety Bonds and Cost

CONTRACT SURETY

- **Bid bond.** Some projects, such as government contracts, require you to secure a bid bond in order to submit your bid. The bond ensures that if you are awarded the bid, you will enter into the contract within the specified timeframe and provide performance or payment bonds. Bid bonds can also be used to help your business prequalify for private projects. Being able to show that your company qualifies for surety credit gives assurance to the general contractor, owner or customer that the company is financially secure and meets underwriting standards.

- **Performance bonds.** The most common type of surety bonds are performance bonds. They guarantee that the work will be completed as outlined in a specified contract. If the principal defaults on the contract, the obligee has recourse against the principal to explore other options. Similarly, if you require performance bonds from subcontractors, you will have recourse if they default on their subcontract.

- **Payment bonds.** Simply put, this is a bond that guarantees payment. It ensures that the principal will pay all subcontractors, laborers and suppliers for work performed under the contract.

- **Other common bond types.** Many other types of bonds exist, including wage and welfare bonds, warranty or maintenance bonds, release of lien bonds, release of holdback bonds, subdivision or site improvement bonds, and sales tax and use bonds.

Generally, payment and performance bonds are included together under one bond at a cost of 0.75% to 3% of the contract price; however, there are situations where the pricing could vary depending on contract scope, project duration/warranties and financial review of the applicant.

COMMERCIAL SURETY

Usually required by government entities, financial institutions and private corporations, commercial surety bonds provide financial protection to the state and its citizens in the event of fraud, theft or other illegal conduct perpetrated by the contractor. The bonds, such as license and permit, guarantee the business will comply with specific rules and regulations to operate within that state.

What Do You Need to Get a Surety Bond?

The "Three C's" of surety — character, capacity and capital — are the backbone of the underwriting process. Before a surety issues a bond, they want to ensure contractors can meet these tenets:

Character: Does the bond applicant (principal) have a credit record and business history that reflects good character and integrity, and a record of fulfilling its obligations?

Sureties will look for:

- References and reputation
- Business relationships with primes, subcontractors and vendors
- Previous owners
- Bank references
- Owner's personal financial statements
- Credit reports

Capacity: Does the principal have the skill, experience, knowledge, staff, equipment and facility necessary to fulfill the contract?

Sureties will analyze:

- Success of past projects
- Current backlog
- Continuity and succession planning
- Systems and controls to manage a project
- Contractual language

Capital: Does the principal have the financial strength to cover the cost of a new project, current obligations and any unforeseen problems that may occur?

Sureties will require:

- Financial statement presentation
- CPA-prepared annual report (compilation, review, audit)
- Interim statements (income statement, balance sheet, cash flow)
- Cost control
- Work-in-progress (WIP) schedules
- Bank line of credit
- Personal financial information

It's imperative to submit accurate and updated information to the surety to acquire the bonds you need.

Why You Need a Good Surety Partner

To avoid unnecessary delays with your submission, it's best to have an experienced broker to facilitate the process of securing a surety bond. Finding surety experts with experience and know-how also will provide you with access to the best resources and a variety of market options.

A good surety partner should be able to guide you through the steps, beginning at the start of the application process by securing the necessary paperwork and financials required by the surety. Skilled surety brokers can also minimize the paper chase between the contractor and surety, and should be able to address red flags and risk concerns prior to the underwriting process.

An experienced surety expert may be able to reduce the application timeline significantly. By understanding what documentation is needed, understanding the markets they partner with and addressing "red flags" early on, a surety expert can help negotiate a bond program that best fits your needs.

The paperwork and documentation your surety broker will need to secure the bond may include:

- The company's organizational chart
- Last three fiscal year-end CPA financial statements on the company. At a minimum, a surety will require financials showing one fiscal year of operations before moving forward, barring extenuating circumstances. In-house statements generally will not satisfy the surety.
- Current contractor's questionnaire
- Work-in-progress (WIP) report
- Current bank reference letter and bank line of credit information
- Current certificate of insurance (COI)
- Company's corporate resume
- Reference letters
- Copy of the contract and bond forms
- Current personal financial statement on each owner (if applicable)

How to Maintain and Maximize Your Surety Program

Communication and transparency are key to maintaining an ongoing relationship with your broker and surety.

Immediately disclose any problems or setbacks so your broker can assist you. Providing regular job progress reports and timely and frequent financial updates (semi-annually, quarterly, etc.), as well as addressing any bond needs with your broker, will make your business stronger financially and contribute to increased bonding capacity.

Assurance — NOT Insurance

Remember, general liability insurance protects you and your business. A policy is bought once, and it covers every job for such things as construction mistakes and accidents.

A surety bond primarily protects the customer and covers a single job contract, but it can be tapped to help your business if you're experiencing difficulties, such as cash-flow issues for supplies, labor, etc. during a project.

Contact HUB's **surety experts** to learn more about contractor surety bonds that protect your customers, as well as you, your business and ultimately, your reputation.

Strategic support that puts you in control.

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For more information on how to manage your insurance costs and reduce your risk, contact a HUB construction insurance specialist.

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