Surety Bond Requirements for Construction Projects

Notes:*A surety bond is not an insurance policy. A surety bond is a guarantee, in which the surety guarantees that the contractor, called the "principal" in the bond, will perform the "obligation" stated in the bond. For example, the "obligation" stated in a bid bond is that the principal will honor its bid; the "obligation" in a performance bond is that the principal will complete the project; and the "obligation" in a payment bond is that the principal will properly pay subcontractors and suppliers. Bonds frequently state, as a "condition," that if the principal fully performs the stated obligation, then the bond is void; otherwise the bond remains in full force and effect.*

If the principal fails to perform the obligation stated in the bond, both the principal and the surety are liable on the bond, and their liability is "joint and several." That is, either the principal or surety or both may be sued on the bond, and the entire liability may be collected from either the principal or the surety. The amount in which a bond is issued is the "penal sum," or the "penalty amount," of the bond. Except in a very limited set of circumstances, the penal sum or penalty amount is the upward limit of liability on the bond.

The person or firm to whom the principal and surety owe their obligation is called the "obligee." On bid bonds, performance bonds, and payment bonds, the obligee is usually the owner. Where a subcontractor furnishes a bond, however, the obligee may be the owner or the general contractor or both. The people or firms who are entitled to sue on a bond, sometimes called "beneficiaries" of the bond, are usually defined in the language of the bond or in those state and federal statutes that require bonds on public projects.

Types of Surety Bonds

BID BONDS
A bid bond guarantees the owner that the principal will honor its bid and will sign all contract documents if awarded the contract. The owner is the obligee and may sue the principal and the surety to enforce the bond. If the principal refuses to honor its bid, the principal and surety are liable on the bond for any additional costs the owner incurs in reletting the contract. This usually is the difference in dollar amount between the low bid and the second low bid. The penal sum of a bid bond often is ten to twenty percent of the bid amount.

PERFORMANCE BONDS
A performance bond guarantees the owner that the principal will complete the contract according to its terms including price and time. The owner is the obligee of a performance bond, and may sue the principal and the surety on the bond. If the principal defaults, or is terminated for default by the owner, the owner may call upon the surety to complete the contract. Many performance bonds give the surety three choices: completing the contract itself through a completion contractor (taking up the contract); selecting a new contractor to contract directly with the owner; or allowing the owner to complete the work with the surety paying the costs. The penal sum of

the performance bond usually is the amount of the prime construction contract, and often is increased when change orders are issued. The penal sum in the bond usually is the upward limit of liability on a performance bond. However, if the surety chooses to complete the work itself through a completing contractor to take up the contract then the penal sum in the bond may not be the limit of its liability. The surety may take the same risk as a contractor in performing the contract.

PAYMENT BONDS

A payment bond guarantees the owner that subcontractors and suppliers will be paid the monies that they are due from the principal. The owner is the obligee; the "beneficiaries" of the bond are the subcontractors and suppliers. Both the obligee and the beneficiaries may sue on the bond. An owner benefits indirectly from a payment bond in that the subcontractors and suppliers are assured of payment and will continue performance. On a private project, the owner may also benefit by providing subcontractors and suppliers a substitute to mechanics' liens. If the principal fails to pay the subcontractors or suppliers, they may collect from the principal or surety under the payment bond, up to the penal sum of the bond. Payments under the bond will deplete the penal sum. The penal sum in a payment bond is often less than the total amount of the prime contract, and is intended to cover anticipated subcontractor and supplier costs.

MAINTENANCE BONDS

The role of a maintenance bond is to protect against design defects and/or failures in workmanship, and to guarantee that the project constructed will be regularly and adequately maintained throughout the maintenance period. Maintenance bonds are often for a limited amount of time such as one to three years.

Construction is a risky business. Besides liability and property damage to the project risks in construction projects there are other risks in letting a construction contract including these risks:

a. The apparent low bidder will not accept the award at the bid price and furnish the required performance and payment bonds.

b. The contractor will not be able to complete the project in accordance with the plans and specifications for the contract price.

c. Incurred labor and material bills will not be paid by the contractor, resulting in loss to the owner. These risks can be mitigated and transferred by various bonds executed by a competent and financially sound surety company.

What Bonds Should Be Required?

Performance bonds protect the owner from contractor default and delays, and these are important for commercial properties with fixed tenant availability dates. Payment bonds protect the property from mechanics' liens, which might otherwise interfere with sale or refinancing of the property. Bid bonds, which generally address only the price-spread between the low and next to lowest bid price, serve a much narrower purpose. However, because of the expectations and requirements of the bid package, corporate sureties generally will issue bid bonds only to contractors who qualify for performance and payments bonds. Thus a requirement for a bid bond may help narrow the field of bidders to only those firms who can actually satisfy performance and payment bond requirements.

What Surety Companies are Acceptable to the Owner?

Since a surety bond essentially is a guarantee by the surety, the owner has an interest in deciding which sureties are acceptable. The Surety shall be licensed to do business in the State of Washington and are named in the current list of "Surety Companies Acceptable in Federal Bonds" as published in the Federal Register by the Audit Staff Bureau of Accounts, U.S. Treasury Department.

Specifying the Amount of Bonds

Premiums rise along with the penal sum of the bond, and the owner ultimately pays these costs in the contract price. Nonetheless, the owner has an interest in setting the bond penal sum high enough to provide the desired protection to the project. The penal sum for the performance bond should be one hundred percent of the original contract price, and the penal sum should be increased for each change order.

The following requirements should be incorporated into the appropriate contract documents:

Performance and Payment Bonds

At such time as contractor/bidder enters into a contract, he/she shall provide a performance and labor & materials payment bond in the amount of 100% of the awarded contract as security for the faithful performance and payment of all his/her obligations under the specifications. Bond shall be in a form acceptable to the [City/State/City Attorney.]

Surety shall be licensed to conduct business in the State of Washington and are named in the current list of "Surety Companies Acceptable in Federal Bonds" as published in the Federal Register by the Audit Staff Bureau of Accounts, U.S. Treasury Department.

Maintenance Bond

If required, contractor will provide a maintenance bond guaranteeing work shall be free of any defective materials or workmanship which became apparent during the period of [years] following completion of the Contract. Bond shall be in a form acceptable to the [City/State/City Attorney]. Bond shall be in the amount of [10%-100%] of the contract price.

Surety shall be licensed to conduct business in the State of Washington and are named in the current list of "Surety Companies Acceptable in Federal Bonds" as published in the Federal Register by the Audit Staff Bureau of Accounts, U.S. Treasury Department.

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