Surety Bonds in Construction

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What is Surety?

- What is surety, suretyship, a surety bond?

What is Surety?

- The surety industry more closely reflects and has more in common with what other major financial services industry ?

What is Surety?

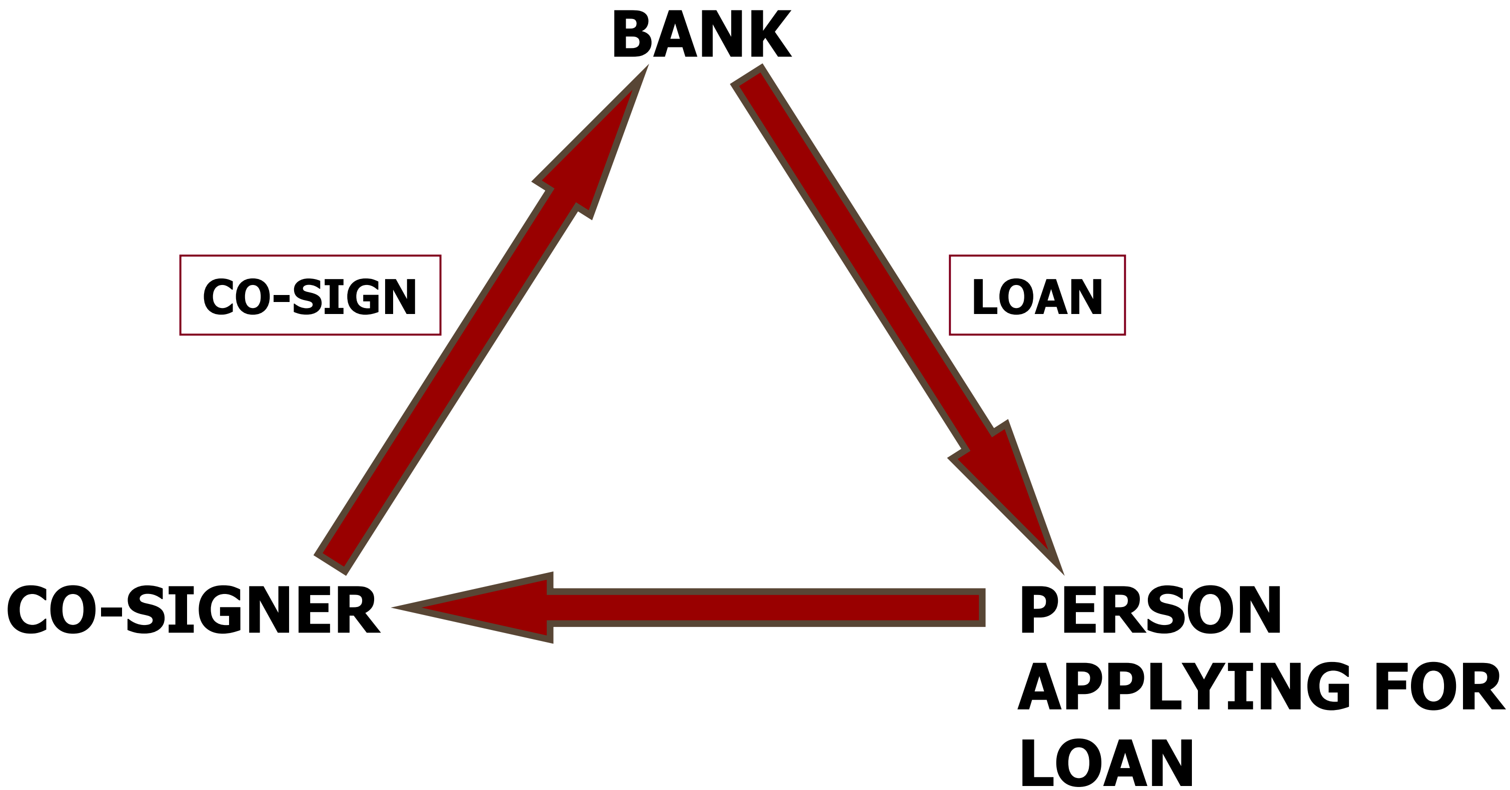
“The surety industry more closely reflects and has more in common with the banking industry”

in other words…

“Surety is a form of Credit”

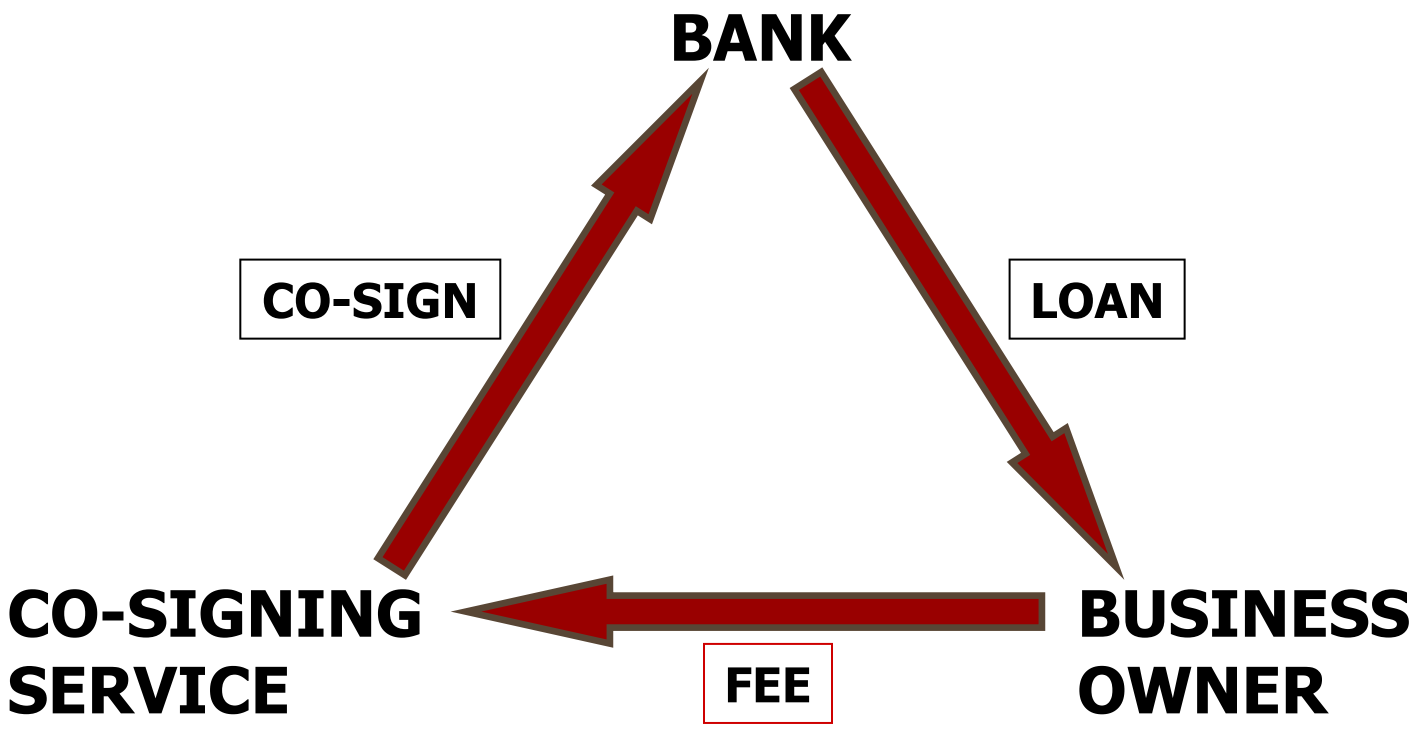
Surety is a form of Credit

A good analogy is co-signing a bank loan



Surety is similar to a commercial Bank Loan

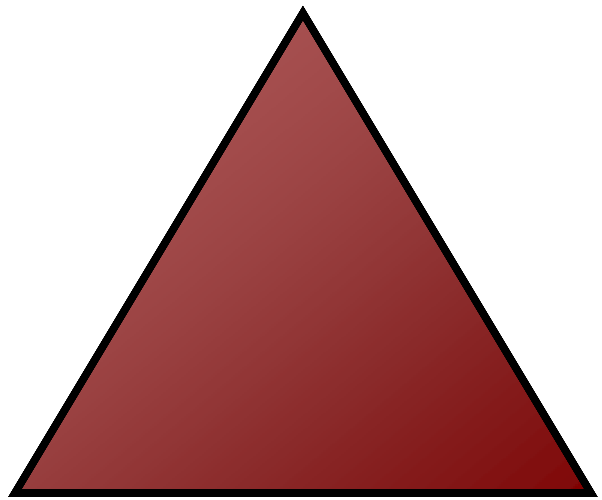
“One Person’s Opinion of Another’s Abilities”



Surety is a 3-Party Relationship

Surety guarantees completion of the project in case of default on the part of the Principal (guarantees performance)

OBLIGEE
(project owner)



SURETY

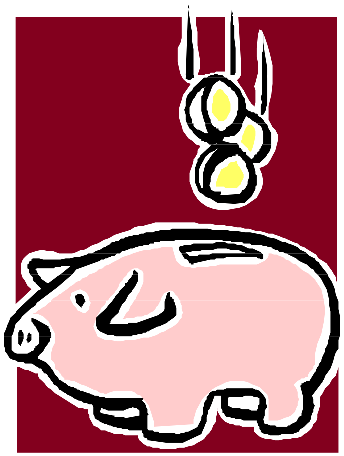
PRINCIPAL
(contractor)

Prequalification – The 3 "C"s of Suretyship

CHARACTER

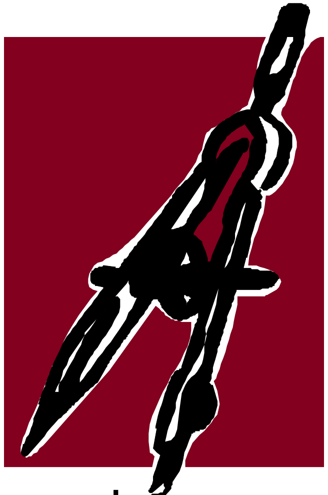
based on:
- impressions
- "Gut feelings" about management
- letters of reference
- person of integrity

CAPITAL



based on:
- financial records
- financial stability
- financial history
- current work load

CAPACITY



based on:
- company experience
- employee's experience
- physical assets
- proven track record

The Benefits of Prequalification

- Gives Assurance of Completion (through Performance Bond)
- Weeds out unqualified bidders
- Guarantees that certain labourers, subcontractors, and suppliers will be paid
- Often lowers the cost of construction by facilitating competitive bids

Insurance vs. Suretyship

- 2-party agreement
- Premium is calculated on a **predicted loss** rate to accumulate a pool to pay the losses
- Insurance is cancelled by either party giving due notice
- Insurer's liability is primary

- 3-party agreement
- Bond premium is for the credit facility - the prequalification fee Based upon **zero** losses!
- Bonds can't be cancelled. Remain in full force and effect until Principal's obligation has been fully performed
- Surety's liability is **secondary –** the Principal has to be in default Principal always carries the primary obligation

Timeline covering a typical Construction Project

Tender Validity Period

Construction Sub-Phase

Maintenance Sub-Phase

Design/ Planning Phase | **Bid/Tender Phase** | **Contract Phase**

Date	Event
Feb 1/06	Owner determines the need to build a warehouse and hires an Architect to do the **Design**.
Apr 1/06	**Tender Call** is made public. Plans & Specifications are made available to interested Contractors.
May 1/06	Closing Date (**Bid/Tender Date**) Required bid security being a 10% Bid Bond (tender acceptance period being 60 days) and Consent of Surety for 50/50 Final Bonds.
Jun 1/06	Actual award of the job.
Jul 1/06	Last day for Owner to duly award the job.
Aug 1/06	**Contract Date** (day upon which a formal Contract is entered into between the Owner & Contractor) Required contract security being 50% Performance & 50% LMP bonds, there being a contractual 1 year maintenance.
Nov 1/06	Date of **Substantial Completion**. 1 year Maintenance Period commences.
Nov 1/07	**Maintenance Period** expires if no Notice of any Defect was received by the Surety during the 1 year Maintenance Period. The Performance bond would then be deemed **Null & Void**.

Bid Bond

When: at the tender stage (most common form of bid security)

Why: prequalification guarantees good faith of the bidder

If the following occur… (*1st part of sentence*)
• must *award* job to the contractor
• they must enter into a formal *contract*
• contractor will have to provide contract security (performance & payment bond)
then bid bond is considered *null and void.*

If not met... (*2nd part of sentence*)
-conditions are listed

What is the *implied condition* put upon the Obligee?
Contract must be awarded within tender acceptance period

Bid Bond Wording – CCDC

The condition of this obligation is such that if the Principal shall have the bid accepted within the time period prescribed in the Obligee's bid documents, or if no time period is specified in the Obligee's bid documents, within ________ (__) days from the closing date as specified in the Obligee's bid documents, and the Principal enters into a formal contract and gives the specified security, then this obligation shall be void; otherwise, provided the Obligee takes all reasonable steps to mitigate the amount of such excess costs, the Principal and the Surety will pay to the Obligee the difference in money between the amount of the bid of the Principal and the amount for which the Obligee legally contracts with another party to perform the work if the latter amount be in excess of the former.

Performance Bond

When: when contract is entered into between Principal & Obligee

Why: to guarantee the performance of the contract

**In case of contractor default,
the Surety has the following options:**

- Fund the defaulting contractor to complete the work
- Hire construction personnel to complete the work
- Re-tender the remaining balance of the work

or

- WORST-CASE SCENARIO: If the work is in disastrous shape, write a cheque for the amount of the performance bond (it then becomes the owner's problem)

Performance Bond Wording – CCDC

The condition of this obligation is such that if the Principal shall promptly and faithfully perform the Contract then this obligation shall be null and void; otherwise it shall remain in full force and effect.

Whenever the Principal shall be, and declared by the Obligee to be, in default under the Contract, the Obligee having performed the Obligee's obligations thereunder, the Surety may promptly:

1) remedy the default, or;

2) complete the Contract in accordance with its terms and conditions, or;

3) obtain a bid or bids … of the lowest responsible bidder … or;

4) pay the Obligee …

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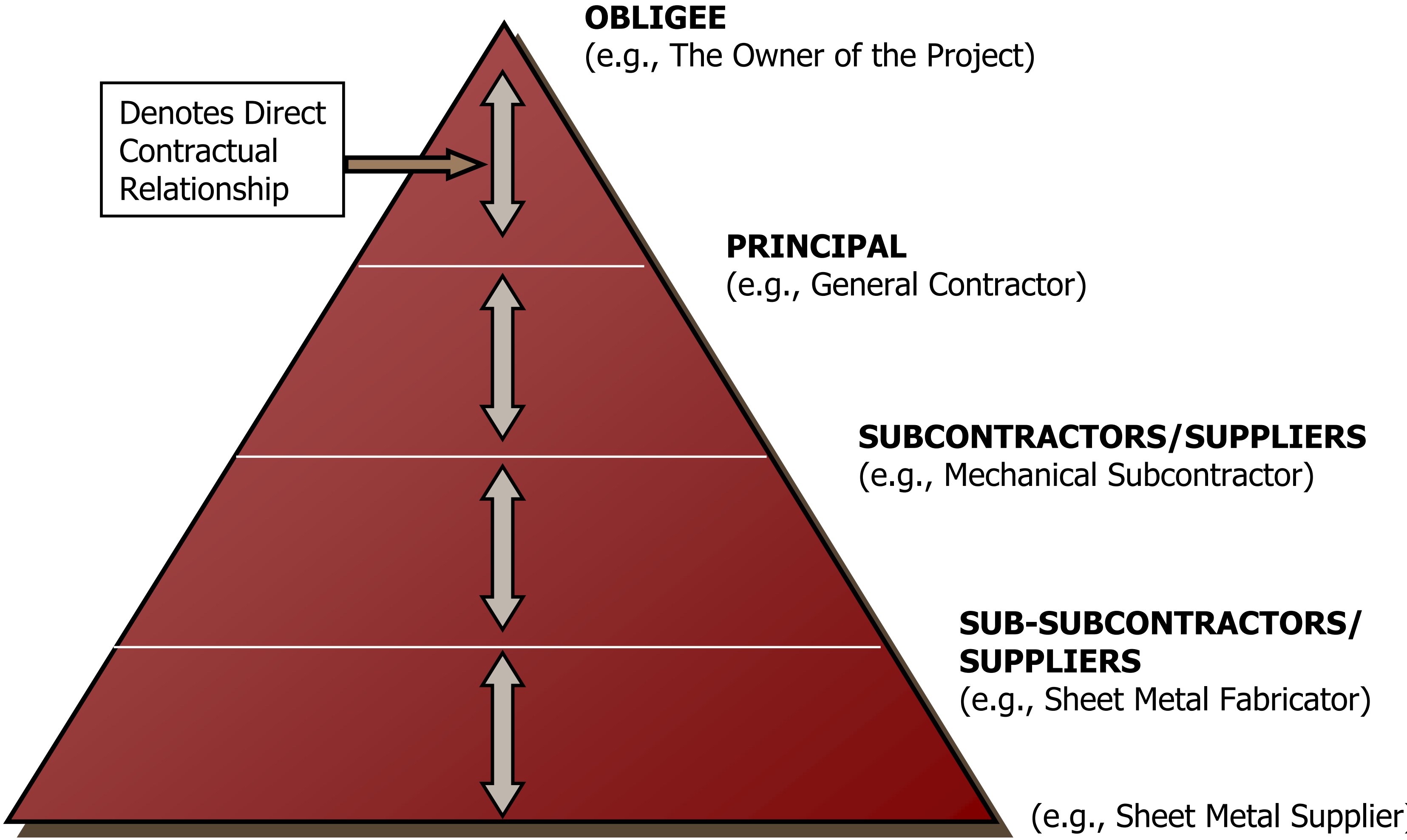
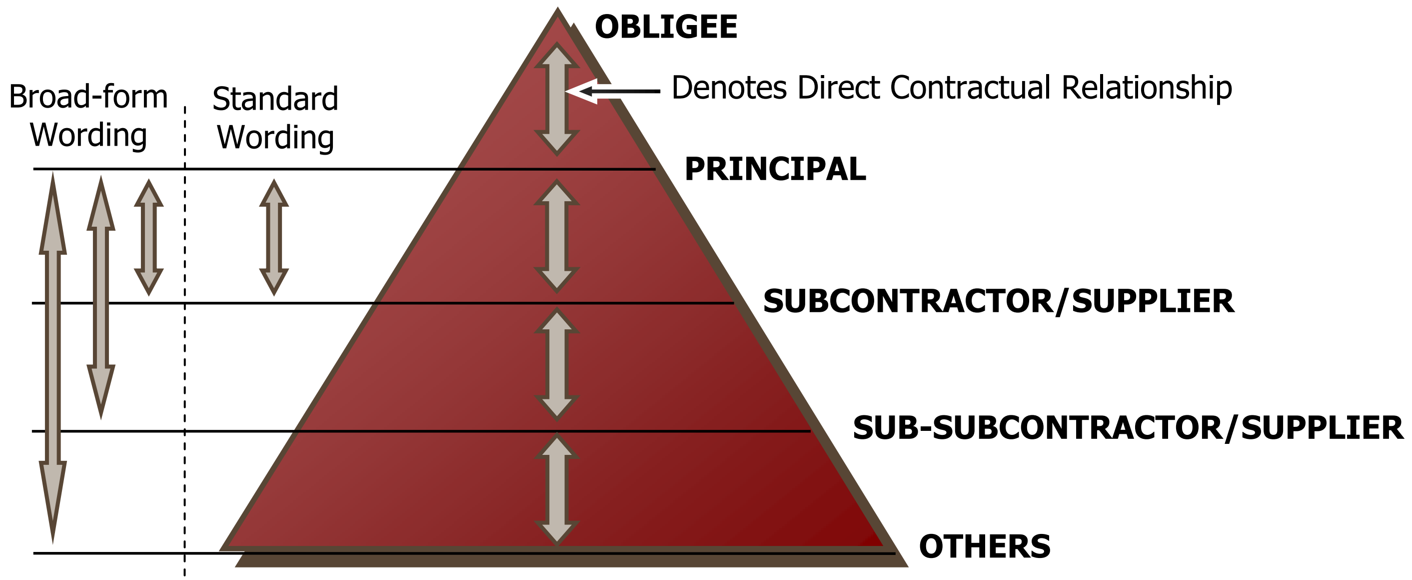
Typical Construction Pyramid



Labour and Material Payment Bond

When: when contract is entered into between Principal & Obligee

Why: to guarantee payment to those with direct (and sometimes indirect) contracts with Principal for goods and services supplied to the project



L&MP Bond Wording – CCDC

CCDC "Standard" Wording

The Condition of this obligation is such that, if the Principal shall make payment to all Claimants for all labour and material used or reasonably required for use in the performance of the contract, then this obligation shall be null and void; otherwise it shall remain in full force and effect, subject, however, to the following conditions:

1. **A Claimant for the purpose of this Bond is defined as one having a direct contract with the Principal for labour, material, or both, used or reasonably required for use in the performance of the Contract…**

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L&MP Bond Wording – Gov't of Canada

Government of Canada "Broad-Form" Wording

NOW, THEREFORE, THE CONDITIONS OF THIS OBLIGATION are such that, if payment is promptly made to all Claimants who have performed labour or services or supplied material in connection with the Contract and any and all duly authorized modifications and extensions of the Contract that may hereafter be made, notice of which modifications and extensions to the Surety being hereby waived, then this obligation shall be void, otherwise it shall remain in full force and effect, subject, however, to the following conditions:

(1) For the purpose of this Bond, a Claimant is defined as one having a direct contract with the Principal or any Sub-Contractor of the Principal for labour, material or both, used or reasonably required for use in the performance of the Contract …

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Indemnity Agreement

When:

• authorized and signed when a surety facility is established

• comes into effect if/when contractor fails

Whom:

• operating company, any related, affiliated, or subsidiary companies, major shareholders and their spouses

Why:

• Guarantee that the Surety will be paid back in full by Principal for any losses from the indemnitors (may include personal worth of shareholders)

However…

it is *very* difficult to collect money because default is often caused by **Bankruptcy** (therefore no money left over)

Other Bonds

Release of Holdback

- **When**: At any time during the course of construction
- **Why**: Allow owner to release the majority of the Holdback if most of the work is completed satisfactorily

Consent of Surety

(a.k.a. Agreement to Bond)

- **When**: At Tender
- **Why**: Guarantee that Surety will issue final bonds if tender accepted and contract entered into

NB: a Consent of Surety is not an official bond, but is heavily used by bonding companies

Other Bonds

Supply Bond

• **When:** Contract Awarded

• **Why**: Same as Performance Bond, except principal does not build anything - Guarantee the supply only

Maintenance Bond

• **When**: After completion certificate issued

• **Why**: Evidence of the Maintenance guarantee for materials and workmanship

(1 or 2 years preference - sometimes surety will provide longer)

Risk Mitigation Criteria
“No Bond from a Subcontractor”

Criteria to be considered in not bonding a Subcontractor:

- Ability to bond
- References
- Size of subcontract
- Length of time in business
- Difference in price to next bidder
- Past record with the subcontractor
- Present Workload
- Personnel assigned to project
- Financial strength and capacity of the subcontractor
- How far into the future will the work be executed
- Similar type project experience
- Other forms of security (eg: letter of credit, chattel mortgage, etc.)
- Ability to monitor supplier and labour payments, statutory declarations, etc.

Risk Mitigation Strategy
"No Bond from a Subcontractor"

To reduce risk - when a Sub is not bonded:

- Bank References and Credit Checks (Equifax/Creditel, discussions with suppliers, etc.)
- Bond sub-subs or subcontract directly with sub-subs
- Purchase material directly, bypassing subs
- Monthly check on supplier payments
- Monitor payments to workers
- Obtain letter of credit or other forms of security
- Obtain financial statements from subcontractor
- Obtain assignment and issue joint cheques to subcontractor and his suppliers/sub-subs

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Risk Mitigation Documentation for any Construction Project

Early in each project there should be a listing prepared which outlines the following information:

- List of subcontractors
- Trade Scope
- Contract Value
- Bonded or not

“This list should be completed soon after awarding of all subcontracts and should be made available for senior management review”

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Thank You

Any Questions?

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