



The Consumer's Guide to

Surety Bonds

Surety bonds are an incredibly important tool for managing and mitigating risk in the business world. They are an essential and often mandatory production element for contractors.

In short, surety bonds offer financial security for communities, developers and other stakeholders that contractors will do their work, pay subcontractors and perform other mutually agreed-upon duties. Surety bonds are agreements among a surety company, an obligee (owner) and the principal (contractor), where the surety ensures the contract is followed and parties are paid as necessary.

Sureties, which in many cases are umbrella entities within insurance companies, utilize a highly critical process to assess contractors before deciding whether to accept the risk of a given project. Surety bonds help protect public tax dollars and private investment by providing a foundation of security.

As an industry, contractors continue to have a relatively high rate of failure, and contractor defaults do occur. Those surety bonds help keep project directors and taxpayers safeguarded from harm.

There are myriad types of surety bonds, cutting across a wide spectrum of industries and business sectors. Surety bonds have become especially integral in the construction and contracting fields. In fact, surety bonds are required by law for some public works projects.

Enacted in 1935, the Miller Act remains the federal standard for mandating surety bonds on federal public works projects. Bonds are required for all contracts worth more than \$100,000, and payment protection is mandatory for those in excess of \$25,000. Most states have passed similar laws requiring risk mitigation and bonding for public projects.

The U.S. Small Business Administration also offers a surety program for small businesses. The SBA can guarantee bonds for contracts up to \$2 million, covering bid, performance and payment bonds for small and emerging contractors who cannot obtain surety bonds through regular commercial channels. SBA's guarantee gives sureties an incentive to provide bonding for eligible contractors, and thereby strengthens a contractor's ability to obtain bonding and greater access to contracting opportunities.



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Contract Bonds

There are three basic types of contract surety bonds: bid bonds, performance bonds and payment bonds. Here's a brief explanation of those major bonds as well as some other standard construction industry bonds:

- **Bid Bond:** Ensures that a contractor can accept a project for the specified price as the lowest acceptable bidder. If a contractor refuses to commence work, the bid bond allows the project developer to recoup the difference between the lowest bid and the second-lowest bid.
- **Performance Bond:** These give project owners and developers financial protection against a contractor that defaults or fails in some way to perform work as specified in the contract.
- **Payment Bond:** Ensures that the contractor will pay subcontractors, suppliers and laborers as detailed in the contract. It is common to see payment and performance bonds issued together as a single bond.
- **Site Improvement Bond:** Ensures that a contractor makes proper improvements to existing structures, as per existing building codes. These bonds also guarantee that public property will receive improvements in accordance with applicable governmental regulation.
- **Subdivision Bond:** These bonds ensure that improvements to a subdivision property are completed as specified in a contract. Local authorities typically mandate these bonds. They are similar to site improvement bonds, except that subdivision bonds are for new structures, while site improvement bonds govern existing structures.
- **Supply Bond:** These ensure that a project supplier will provide materials as detailed by the contract. These are either mandated by regulation or by a project owner for public construction projects. In the event of default, the surety underwrites the supply purchaser against any loss.

Commercial Bonds

There are hundreds of different types of commercial surety bonds. They will at times be referred to as non-contract bonds because they do not guarantee specific contracts or elements of contracts. But consumers will often hear the phrase "license and permit bond," as these types of commercial bonds represent a major chunk of the sector.

Local municipalities and states often require license and permit bonds. Commercial bonds can cover anything from mortgage brokers and auto dealers to telemarketers.

Here are a few examples of commercial surety bonds:

- **Mortgage Broker Bond:** These are required for mortgage brokers, lenders and bankers in almost every state. These bonds ensure the veracity of a broker's license, providing protection for consumers.
- **Auto Dealer (MVD) Bond:** These surety bonds help protect states against auto dealers, ensuring they operate according to state laws and regulations. There are several names for auto dealer bonds, including MVD bonds, DMV bonds, user car dealer bonds or simply auto dealer bonds.
- **Medicare (DMEPOS) Bond:** Aimed at curbing medical fraud and malpractice, these newer bonds are required for manufacturers and suppliers of durable medical equipment, prosthetics, orthotics and supplies (DMEPOS). Enacted in January 2009, this bonding requirement mandates a company post a \$50,000 surety bond except in certain limited cases.
- **Contractor License Bond:** In short, these bonds guarantee that contractors will adhere to state and local laws and regulations. These are different from contract bonds and are typically filed with a contractor's license.
- **Sales Tax Bond:** These unique bonds provide state and local governments with a guarantee that a business will pay its taxes. These bonds do not require collateral. Businesses that fail to pay can find themselves in serious trouble, including facing a bond claim.

Judicial Bonds

There are several different types of judicial, or court-related, bonds. These can protect businesses, communities and individuals in the face of criminal or civil tort acts and litigation. Here are several prominent types:

- **Fidelity Bond:** These bonds can protect business owners and employers from monetary or property loss at the hands of employees. Some businesses, including insurance companies, are required to utilize fidelity bonds.

- **Injunction Bond:** This specific judicial bond ensures that if a person obtains an injunction under false pretenses, he or she will be liable for damages. These bonds protect people who are wrongly accused and wind up taking a financial hit because of a false injunction.
- **Appeal Bond:** These bonds are typically filed by an individual who has lost in court and is seeking an appeal to a higher court. Appeal bonds guarantee the execution of the fiduciaries' duties in the event the appeal fails.
- **Attachment Bond:** Attachment is a legal term that involves the taking of a defendant's property into court custody before a trial. In many states, a plaintiff will have to post an attachment bond that guarantees he or she will pay damages if the attachment is later deemed wrongful.

What Do Bonds Cost?

It's difficult to pinpoint an exact cost or a common charge for bonds, as their cost depends on a host of factors, including the applicant and its financial health, the type of bond and the surety. Premium costs for bonds might range from 1 to 4 percent. But those who wind up categorized in the high-risk market might pay anywhere from 5 percent to 20 percent of the bond amount.

The nature of bond underwriting is fluid and rapidly changing, given economic realities within a given industry and the market as a whole. Unlike with insurance, there is little expectation of loss with surety bonds. Because of that, the bond premium is typically meant to cover prequalification services, namely the underwriting.

Surety companies will examine contractors methodically before issuing a bond. They will typically scrutinize a company's financial strength and credit history; its references, reputation and ability to perform current and future work; and the firm's management structure and hierarchy, just to name a few.

Even those with bad credit can obtain surety bonds. But remember that high-risk bonds will often come with a significantly higher premium cost.

Surety Bonds Glossary

Bid Bonds

A bond meant to guarantee that a bidder of a contract (i.e. construction contract) enters that bid in good faith and will properly execute the contract if the bid is successful.

Commercial Bonds

Bonds required by businesses (other than contractors) to guarantee completion of service.

Contract Bonds

A bond that provides financial security and construction assurance on building/construction jobs. It assures the project owner that the contractor will perform the contracted work and/or pay subcontractors, laborers, and suppliers.

Fidelity Bonds

A bond issued to protect an employer from financial or property losses due to the dishonesty of employees. Often these bonds are issued when an employer hires "high risk" employees

License and Permit Bonds

Bonds required to obtain a license or permit from a city, county, state, or occasionally the federal government. The purpose is usually to safeguard the public.

Obligee

The party a bond protects from loss; the beneficiary of the bond. For example the project owner on a construction site.

Payment Bonds

A bond given to guarantee payment, usually of a contractor to sub-contractors and suppliers. This is frequently the only protection offered those supplying work or materials to a public job

Performance Bonds

Bonds guaranteeing performance of the terms of a contract. These protect the owner of the contract from financial loss should the contractor refuse or be unable to fulfill the contract obligations.

Principal

The person or business whose obligations are guaranteed by a bond

Surety

A person (or entity), who is legally responsible for the contracts, debt, delinquency, or liability of another

Surety Bonds

A Bond that is a three party agreement between a contractor (Principal), the project owner (Obligee), and the surety company. The bond insures that the contracted work will be completed on time and on budget and will cover any losses incurred by poor contract performance