Chapter 7

Contract Surety Bonds

7.1 SURETY BONDS IN CONSTRUCTION

The use of contract surety bonds in the construction industry is but one of many applications of surety bonds in business and commerce. In law, a surety is a party that assumes liability for the debt, default, or failure in duty of another. A surety bond is the contract that describes the conditions and obligations pertaining to such an agreement. A surety bond is not an insurance policy. Rather, it serves as an extension of credit by the surety, not in the sense of a financial loan, but as an endorsement. Insurance protects a party from the risk of loss, whereas suretyship guarantees the performance of a defined contractual duty.

By the terms of a construction contract bond the surety agrees to indemnify the owner, called the obligee, against any default or failure in duty of the prime contractor, called the principal. Contract bonds are three-party agreements that guarantee that the work will be completed in accordance with the contract documents and that all construction costs will be paid. When the contractor properly discharges its obligations and after any warranty period covered by the bond expires, the bond agreement is discharged and no longer has any force or effect. Regardless of the reason, if the prime contractor fails to fulfill its contractual obligations, the surety must assume the obligations of the contractor and see that the contract is completed, paying all costs up to the face amount of the bond. It should be noted that dual obligee bonds are sometimes used. Such bonds protect both the owner and the lending institution that advances construction funds to the owner. The need for surety bonds is a consequence of the fact that construction is a very risky business. Past experience suggests that approximately one-half of all construction contracting firms now in operation will not be in business seven years from now.

A contract bond form is a simple document that makes no attempt to describe in detail the specific liabilities of the surety. The bond guarantees the construction contract in all of its provisions, and the obligations of the bond are identical with the provisions of the contract. The bond does not impose on the surety any obligations that are separate from, or in addition to, those assumed by the general contractor. By the same token, by being bonded, the contractor assumes no additional obligation to the owner that it has not already assumed by contract or by operation of law. The bond can be invoked by the owner only if the contractor is in breach of contract. The statutes of frauds of the various states require that contracts of suretyship must be in writing to be enforceable. For this reason, contract bonds are always written documents.

Contract bonds are not required of the contractor on all construction projects. Although such bonds are required by law on public jobs, not all private construction is bonded. This [illegible] invitational bidding or negotiation is used. With regard to contract bonds, the owner must keep one important fact in mind. Contract bonds cannot be viewed as a satisfactory substitute for an able, honest, adequately financed contractor. Unfortunately, owners must sometimes look to the surety for job completion and make the best of a bad situation.

7.2 FORMS OF CONTRACT BONDS

By the terms of the construction contract with the owner, the prime contractor accepts two principal responsibilities: to perform the objective of the contract and to pay all costs associated with the work. Both of these obligations can be included within a single bond instrument, and combined performance and payment bonds are written on a few projects, almost all of which are privately financed. However, it is usual practice for construction contracts to require two separate contract bonds, one bond covering performance of the contract and the other guaranteeing payment for labor and materials. The separate forms bear the endorsement of the American Institute of Architects, the Associated General Contractors, and others, and virtually all statutory bonds on public work are on separate forms.

Under the single type of bond, there is a potential conflict of interest between the owner and the persons furnishing labor and materials. Because the owner has priority, the face value of the bond can be entirely consumed in satisfying its claims. Thus, in many instances the single bond form has afforded little or no protection for material dealers, workers, and subcontractors. In addition, there have been serious problems with the priority of rights of the persons covered. The double form of bond covers separately the interest of the owner and that of subcontractors, material suppliers, and workers. The premium cost of the bond protection is not increased by furnishing two separate bonds rather than one.

7.3 PERFORMANCE BONDS

The owner is entitled to receive what it contracted for or the equivalent. A performance bond acts primarily for the protection of the owner. It guarantees that the contract will be performed and that the owner will receive its structure, built in substantial accordance with the terms of the contract. A performance bond incorporates, by reference, the terms of the contract, and the responsibility of the contractor is the measure of the surety's obligation. On the contractor's default, the burden of contract performance is that of the surety. A performance bond customarily covers any warranty period that may be required by the contract, the usual bond premium including one year of such coverage. All performance bonds, as well as payment bonds, discussed in the following section, have a face value that acts as an upper limit of the expense the surety will incur in finishing the contract, should that action become necessary. This face value is expressed as a fixed sum of money, the amount of which is usually derived from some percentage, 100 percent for instance, of the total contract price.

Figure 7.1 reproduces AIA *Document A312,* "Performance Bond," of the American Institute of Architects and illustrates the provisions of a typical performance bond used on private projects. The standard form used by the federal government provides that the [illegible] contract modifications and that the life of the bond must include all

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AIA Document A312

Performance Bond

Any singular reference to Contractor, Surety, Owner or other party shall be considered plural where applicable.

CONTRACTOR (Name and Address):

SURETY (Name and Principal Place of Business):

OWNER (Name and Address):

CONSTRUCTION CONTRACT
Date:
Amount:
Description (Name and Location):

BOND
Date (Not earlier than Construction Contract Date):
Amount:
Modifications to this Bond: ☐ None ☐ See Page 3

CONTRACTOR AS PRINCIPAL
Company: (Corporate Seal)

Signature: ______________________
Name and Title:

SURETY
Company: (Corporate Seal)

Signature: ______________________
Name and Title:

(Any additional signatures appear on page 3)

(FOR INFORMATION ONLY—Name, Address and Telephone)
AGENT or BROKER:

OWNER'S REPRESENTATIVE (Architect, Engineer or other party):

1 The Contractor and the Surety, jointly and severally, bind themselves, their heirs, executors, administrators, successors and assigns to the Owner for the performance of the Construction Contract, which is incorporated herein by reference.

2 If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond, except to participate in conferences as provided in Subparagraph 3.1.

3 If there is no Owner Default, the Surety's obligation under this Bond shall arise after:

3.1 The Owner has notified the Contractor and the Surety at its address described in Paragraph 10 below that the Owner is considering declaring a Contractor Default and has requested and attempted to arrange a conference with the Contractor and the Surety to be held not later than fifteen days after receipt of such notice to discuss methods of performing the Construction Contract. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and

3.2 The Owner has declared a Contractor Default and formally terminated the Contractor's right to complete the contract. Such Contractor Default shall not be declared earlier than twenty days after the Contractor and the Surety have received notice as provided in Subparagraph 3.1; and

3.3 The Owner has agreed to pay the Balance of the Contract Price to the Surety in accordance with the terms of the Construction Contract or to a contractor selected to perform the Construction Contract in accordance with the terms of the contract with the Owner.

4 When the Owner has satisfied the conditions of Paragraph 3, the Surety shall promptly and at the Surety's expense take one of the following actions:

4.1 Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract; or

4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or

4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Paragraph 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default; or

4.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:

.1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner; or

.2 Deny liability in whole or in part and notify the Owner citing reasons therefor.

5 If the Surety does not proceed as provided in Paragraph 4 with reasonable promptness, the Surety shall be deemed to be in default on this Bond fifteen days after receipt of an additional written notice from the Owner to the Surety demanding that the Surety perform its obligations under this Bond, and the Owner shall be entitled to enforce any remedy available to the Owner. If the Surety proceeds as provided in Subparagraph 4.4, and the Owner refuses the payment tendered or the Surety has denied liability, in whole or in part, without further notice the Owner shall be entitled to enforce any remedy available to the Owner.

6 After the Owner has terminated the Contractor's right to complete the Construction Contract, and if the Surety elects to act under Subparagraph 4.1, 4.2, or 4.3 above, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract. To the limit of the amount of this Bond, but subject to commitment by the Owner of the Balance of the Contract Price to mitigation of costs and damages on the Construction Contract, the Surety is obligated without duplication for:

6.1 The responsibilities of the Contractor for correction of defective work and completion of the Construction Contract;

6.2 Additional legal, design professional and delay costs resulting from the Contractor's Default, and resulting from the actions or failure to act of the Surety under Paragraph 4; and

6.3 Liquidated damages, or if no liquidated damages are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor.

7 The Surety shall not be liable to the Owner or others for obligations of the Contractor that are unrelated to the Construction Contract, and the Balance of the Contract Price shall not be reduced or set off on account of any such unrelated obligations. No right of action shall accrue on this Bond to any person or entity other than the Owner or its heirs, executors, administrators or successors.

8 The Surety hereby waives notice of any change, including changes of time, to the Construction Contract or to related subcontracts, purchase orders and other obligations.

9 Any proceeding, legal or equitable, under this Bond may be instituted in any court of competent jurisdiction in the location in which the work or part of the work is located and shall be instituted within two years after Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond, whichever occurs first. If the provisions of this Paragraph are void or prohibited by law, the minimum period of limitation avail-

able to sureties as a defense in the jurisdiction of the suit shall be applicable.

10 Notice to the Surety, the Owner or the Contractor shall be mailed or delivered to the address shown on the signature page.

11 When this Bond has been furnished to comply with a statutory or other legal requirement in the location where the construction was to be performed, any provision in this Bond conflicting with said statutory or legal requirement shall be deemed deleted herefrom and provisions conforming to such statutory or other legal requirement shall be deemed incorporated herein. The intent is that this Bond shall be construed as a statutory bond and not as a common law bond.

12 DEFINITIONS

12.1 Balance of the Contract Price: The total amount payable by the Owner to the Contractor under the Construction Contract after all proper adjustments have been made, including allowance to the Contractor of any amounts received or to be received by the Owner in settlement of insurance or other claims for damages to which the Contractor is entitled, reduced by all valid and proper payments made to or on behalf of the Contractor under the Construction Contract.

12.2 Construction Contract: The agreement between the Owner and the Contractor identified on the signature page, including all Contract Documents and changes thereto.

12.3 Contractor Default: Failure of the Contractor, which has neither been remedied nor waived, to perform or otherwise to comply with the terms of the Construction Contract.

12.4 Owner Default: Failure of the Owner, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof.

MODIFICATIONS TO THIS BOND ARE AS FOLLOWS:

(Space is provided below for additional signatures of added parties, other than those appearing on the cover page.)

CONTRACTOR AS PRINCIPAL		SURETY	
Company:	(Corporate Seal)	Company:	(Corporate Seal)
Signature: ______		Signature: ______	
Name and Title:		Name and Title:	
Address:		Address:	

7.4 PAYMENT BONDS

A payment bond acts primarily for the protection of third parties to the contract and guarantees payment for labor and materials used or supplied in the performance of the construction. The private owner and the financial institutions providing construction and permanent financing are thereby protected against liens (see Section 9.34) that can be filed on the project by subcontractors, material vendors, workers, and other unpaid parties to the work. Although a private owner ordinarily decides for itself whether to require contract bonds from the contractor, it is worthy of note that there are a few state statutes that require payment bonds on privately financed work. Figure 7.2 presents AIA *Document A312,* "Labor and Material Payment Bond," of the American Institute of Architects. This bond, typical of common-law payment bonds employed by corporate sureties for privately financed projects, provides the following:

1. The claimant must have had a direct contract with either the general contractor or a subcontractor.
2. Labor and materials include water, gas, power, light, heat, oil, gasoline, telephone, and rental of equipment directly applicable to the contract.
3. Written notice must be given by the claimant, other than one having a direct contract with the general contractor, to any two of these: general contractor, owner, or surety, within 90 days after claimant performed its last work or furnished the last of the materials.
4. The owner is exempted from any liabilities in connection with such claims.
5. Claims must be filed in the appropriate court.
6. No claims shall be commenced after the expiration of one year following the date on which the general contractor stopped work, barring a statute to the contrary.

Payment bonds exclude from their coverage parties who are remote from the general contractor. It should be noted that the bond form in Figure 7.2 includes only those claimants who have a direct contract with the prime contractor or one of the subcontractors. Whether specific instances of labor, material suppliers, or sub-subcontractors on public projects are protected by statutory payment bonds depends on the language of the related statute. Because liens cannot be filed against public property, the payment bond may well be the only protection vendors, workers, and subcontractors have for payment on public projects.

It is worthy of note that a subcontractor's supplier may have the right to recover payment under a general contractor's payment bond, even though the general contractor has made payment in full to the subcontractor. In many areas, the prime contractor is, under its bond, subject to double payment obligations if a subcontractor has not paid its suppliers. When the general contractor does not require payment bonds from its subcontractors, it must use special procedures when paying these parties (see Section 9.29).

7.5 STATUTORY AND COMMON-LAW BONDS

Payment bonds are either statutory or common-law, and there are important differences between the two. The bonding requirements on public projects are prescribed by law, and a statutory bond, at least by reference, contains the provisions of the statute that

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AIA Document A312

Payment Bond

Any singular reference to Contractor, Surety, Owner or other party shall be considered plural where applicable.

CONTRACTOR (Name and Address):

SURETY (Name and Principal Place of Business):

OWNER (Name and Address):

CONSTRUCTION CONTRACT
Date:
Amount:
Description (Name and Location):

BOND
Date (Not earlier than Construction Contract Date):
Amount:
Modifications to this Bond: ☐ None ☐ See Page 6

CONTRACTOR AS PRINCIPAL
Company: (Corporate Seal)

Signature: ______________________
Name and Title:

SURETY
Company: (Corporate Seal)

Signature: ______________________
Name and Title:

(Any additional signatures appear on page 6)

(FOR INFORMATION ONLY—Name, Address and Telephone)

AGENT or BROKER:

OWNER'S REPRESENTATIVE (Architect, Engineer or other party):

1 The Contractor and the Surety, jointly and severally, bind themselves, their heirs, executors, administrators, successors and assigns to the Owner to pay for labor, materials and equipment furnished for use in the performance of the Construction Contract, which is incorporated herein by reference.

2 With respect to the Owner, this obligation shall be null and void if the Contractor:

2.1 Promptly makes payment, directly or indirectly, for all sums due Claimants, and

2.2 Defends, indemnifies and holds harmless the Owner from claims, demands, liens or suits by any person or entity whose claim, demand, lien or suit is for the payment for labor, materials or equipment furnished for use in the performance of the Construction Contract, provided the Owner has promptly notified the Contractor and the Surety (at the address described in Paragraph 12) of any claims, demands, liens or suits and tendered defense of such claims, demands, liens or suits to the Contractor and the Surety, and provided there is no Owner Default.

3 With respect to Claimants, this obligation shall be null and void if the Contractor promptly makes payment, directly or indirectly, for all sums due.

4 The Surety shall have no obligation to Claimants under this Bond until:

4.1 Claimants who are employed by or have a direct contract with the Contractor have given notice to the Surety (at the address described in Paragraph 12) and sent a copy, or notice thereof, to the Owner, stating that a claim is being made under this Bond and, with substantial accuracy, the amount of the claim.

4.2 Claimants who do not have a direct contract with the Contractor:

.1 Have furnished written notice to the Contractor and sent a copy, or notice thereof, to the Owner, within 90 days after having last performed labor or last furnished materials or equipment included in the claim stating, with substantial accuracy, the amount of the claim and the name of the party to whom the materials were furnished or supplied or for whom the labor was done or performed; and

.2 Have either received a rejection in whole or in part from the Contractor, or not received within 30 days of furnishing the above notice any communication from the Contractor by which the Contractor has indicated the claim will be paid directly or indirectly; and

.3 Not having been paid within the above 30 days, have sent a written notice to the Surety (at the address described in Paragraph 12) and sent a copy, or notice thereof, to the Owner, stating that a claim is being made under this Bond and enclosing a copy of the previous written notice furnished to the Contractor.

5 If a notice required by Paragraph 4 is given by the Owner to the Contractor or to the Surety, that is sufficient compliance.

6 When the Claimant has satisfied the conditions of Paragraph 4, the Surety shall promptly and at the Surety's expense take the following actions:

6.1 Send an answer to the Claimant, with a copy to the Owner, within 45 days after receipt of the claim, stating the amounts that are undisputed and the basis for challenging any amounts that are disputed.

6.2 Pay or arrange for payment of any undisputed amounts.

7 The Surety's total obligation shall not exceed the amount of this Bond, and the amount of this Bond shall be credited for any payments made in good faith by the Surety.

8 Amounts owed by the Owner to the Contractor under the Construction Contract shall be used for the performance of the Construction Contract and to satisfy claims, if any, under any Construction Performance Bond. By the Contractor furnishing and the Owner accepting this Bond, they agree that all funds earned by the Contractor in the performance of the Construction Contract are dedicated to satisfy obligations of the Contractor and the Surety under this Bond, subject to the Owner's priority to use the funds for the completion of the work.

9 The Surety shall not be liable to the Owner, Claimants or others for obligations of the Contractor that are unrelated to the Construction Contract. The Owner shall not be liable for payment of any costs or expenses of any Claimant under this Bond, and shall have under this Bond no obligations to make payments to, give notices on behalf of, or otherwise have obligations to Claimants under this Bond.

10 The Surety hereby waives notice of any change, including changes of time, to the Construction Contract or to related subcontracts, purchase orders and other obligations.

11 No suit or action shall be commenced by a Claimant under this Bond other than in a court of competent jurisdiction in the location in which the work or part of the work is located or after the expiration of one year from the date (1) on which the Claimant gave the notice required by Subparagraph 4.1 or Clause 4.2.3, or (2) on which the last labor or service was performed by anyone or the last materials or equipment were furnished by anyone under the Construction Contract, whichever of (1) or (2) first occurs. If the provisions of this Paragraph are void or prohibited by law, the minimum period of limitation available to sureties as a defense in the jurisdiction of the suit shall be applicable.

12 Notice to the Surety, the Owner or the Contractor shall be mailed or delivered to the address shown on the signature page. Actual receipt of notice by Surety, the Owner or the Contractor, however accomplished, shall be sufficient compliance as of the date received at the address shown on the signature page.

13 When this Bond has been furnished to comply with a statutory or other legal requirement in the location where the construction was to be performed, any provision in this Bond conflicting with said statutory or legal requirement shall be deemed deleted herefrom and provisions conforming to such statutory or other legal requirement shall be deemed incorporated herein. The intent is that this

Bond shall be construed as a statutory bond and not as a common law bond.

14 Upon request by any person or entity appearing to be a potential beneficiary of this Bond, the Contractor shall promptly furnish a copy of this Bond or shall permit a copy to be made.

15 **DEFINITIONS**

15.1 Claimant: An individual or entity having a direct contract with the Contractor or with a subcontractor of the Contractor to furnish labor, materials or equipment for use in the performance of the Contract. The intent of this Bond shall be to include without limitation in the terms "labor, materials or equipment" that part of water, gas, power, light, heat, oil, gasoline, telephone service or rental equipment used in the Construction Contract, architectural and engineering services required for performance of the work of the Contractor and the Contractor's subcontractors, and all other items for which a mechanic's lien may be asserted in the jurisdiction where the labor, materials or equipment were furnished.

15.2 Construction Contract: The agreement between the Owner and the Contractor identified on the signature page, including all Contract Documents and changes thereto.

15.3 Owner Default: Failure of the Owner, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof.

MODIFICATIONS TO THIS BOND ARE AS FOLLOWS:

(Space is provided below for additional signatures of added parties, other than those appearing on the cover page.)

CONTRACTOR AS PRINCIPAL		SURETY	
Company:	(Corporate Seal)	Company:	(Corporate Seal)
Signature: ______		Signature: ______	
Name and Title:		Name and Title:	
Address:		Address:	

Figure 7.2 *continued*

make the bond a requirement. Private projects use common-law bonds whose coverage and functionings stand entirely on the provisions contained in the bond instrument itself.

The distinction between statutory and common-law bonds is an important matter to the parties for whose protection the payment bond is written. On public projects the action of claimants to obtain protection under the bond must be in accordance with the applicable statute. This applies whether or not the statutory requirements are contained in the language of the bond itself. When payment bonds are required by statute on public projects, the right to recover on them is limited by the conditions of the statute to the same extent as though the provisions of the statute were fully incorporated into the bond instrument. If a claimant fails to comply with the statutory requirements applying to enforcement of rights under the bond, it will not be permitted to recover.

A common-law bond is used when there are no statutory requirements. It is a contract that stands by its own language and that is enforced in the usual manner for contracts. In this case a claimant must proceed as described on the face of the bond.

On private projects the use of the standard common-law payment bond used by the various surety companies is the usual practice. This form is standardized nationally and is approved by professional groups such as the American Institute of Architects. When statutory bonds are required, most public agencies having substantial building programs have developed standard bond forms that conform with the applicable statute. Because the laws pertaining to bonding requirements differ somewhat from one jurisdiction to another, bond forms for public contracts are not standardized nationally. The federal government and many states and municipalities use their own bond forms.

The standard payment bond used by the federal government is written to comply with the provisions of the Miller Act (see Section 7.6). This statutory bond protects laborers, material vendors, and subcontractors who perform work or supply materials for the project, although the extent of this protection depends on how far removed the unpaid party is from the general contractor.

7.6 THE MILLER ACT

The Miller Act prescribes the requirements of performance and of payment bonds used in conjunction with federal construction projects. Enacted in 1935 and subsequently amended, this statute provides that on all federal construction contracts of more than $100,000, the contractor shall furnish a performance bond for the protection of the United States and a payment bond for the protection of persons supplying labor and materials in the prosecution of the work.

The Act provides that the performance bond must be written in such amount that, in the opinion of the contracting officer, the interests of the United States are adequately protected. Under issued regulations of the comptroller general, federal agencies customarily require a performance bond in the amount of 100 percent of the contract amount.

The Construction Industry Payment Protection Act of 1999 makes a number of changes to the Miller Act. Payment bond amounts are now equal to the amount of the performance bond, affording contractors and subcontractors more protection.

To ensure that bonds are supplied to the U.S. government by a financially responsible surety, the U.S. Department of the Treasury maintains a list of surety companies acceptable for federal bonds. This list is updated regularly and can be found at the following website: *www.fms.treas.gov/c570/c570.html*.

The Miller Act gives workers, subcontractors, and material vendors who deal directly with the prime contractor the right to sue on the prime contractor's payment bond if payment is not received in full within 90 days after the date on which the last of the labor was done or the last of the materials were furnished. The law further provides that any person having a direct contractual relationship with a subcontractor, but no contractual relationship with the prime contractor, will have a right of action on the prime contractor's payment bond, provided the claimant gives written notice to the prime contractor within a 90-day period. There is no requirement for notice in the case of a party who deals directly with the prime contractor.

Under the Miller Act, first-tier subcontractors and material suppliers and second-tier subcontractors and material suppliers are protected, but the payment protection of this federal statute extends no further. In addition, second-tier parties must deal with first-tier subcontractors. A subcontractor under the Miller Act has been held to mean one that performs for the prime contractor a specific part of the labor or material requirement of the project. Thus, the term *subcontractor* has been construed by the courts to include a party who supplies custom-made materials but does not install them. An unpaid bond claimant cannot sue on the payment bond until 90 days after the last of the labor was performed or the last of the materials was delivered. However, suit must be brought within one year after last work or delivery. Suits authorized by law are brought in the name of the United States, for the use of the party suing, in the appropriate district court. Suit is brought and prosecuted by the unpaid party's own attorney.

Since passage of the Miller Act, all 50 states have followed with the enactment of their own "Little Miller Acts." These statutes apply to projects financed by the states and establish contract bond requirements similar to those imposed by the Miller Act. These state bonding statutes do differ, however, with regard to which parties can recover under the payment bond.

7.7 CLAIMS FOR PAYMENT

An unpaid party to the construction process who looks to the prime contractor's payment bond for compensation must process its claim in accordance with the terms of the bond instrument on private projects or the governing statute on public work. The processing of such a claim is a technical procedure requiring the services of an attorney. However, attorney's fees cannot normally be collected by a Miller Act claimant. To perfect a claim, the claimant must be generally aware of the notice and time requirements involved. On a private project, the unpaid party can obtain a copy of the payment bond from the owner, surety, or architect-engineer. Public owners or surety companies can provide information concerning statutory claim requirements.

The party seeking compensation may be required to give written notice of the outstanding debt. However, the notice requirement varies with the type of owner involved and the form of payment bond used. On most private projects, no notice is required from an unpaid party that is in contract with the principal (general contractor) on the payment bond. Notice to any two of the bond principal, owner, or surety is needed if the unpaid party has no contract with the principal. Under the Miller Act, which prescribes bonding requirements on federal government construction, one in privity of contract with the prime contractor has no notice requirement. Otherwise, notice must be given to the prime contractor.

Where written notice of an unpaid debt is required, this must be given within a specified period of time. Under the Miller Act and the usual bond forms used on private work, a claimant that was not in contract with the prime contractor must give notice within 90 days after furnishing the last work or material for which the claim is made. An unpaid party must bring suit on the payment bond within the time limits specified by the bonding statute on public works or by the bond instrument itself on private jobs.

7.8 CONTRACT CHANGES

Construction contracts typically give the owner the right to make changes in the work. Because the contract comes before the bond and the bond guarantees the contract, it is commonly assumed that extension of the contract bond to include changes in the contract is provided for automatically. However, the construction contract is between the owner and the contractor, and in the event of changes, the surety is put in the position of being obligated by the terms of a contract to which it is not a party. Common law does not allow two contracting parties to bind a third without its consent. For this reason it is always advisable for the owner to obtain the prior written consent of the surety to any change or modification of the contract. For instance, it is advisable that an executed consent-of-surety form be attached to each project change order. Approval of a contract change in writing is needed because of the aforementioned application of statutes of frauds to contracts of suretyship.

One aspect of the matter of contract modification is that it is possible for the surety to be exonerated from its original obligation, regardless of any provision in the construction contract that changes to the contract do not release the surety under any bond previously provided. Each such case is decided on the facts of the particular situation, and the court record is not entirely clear on this matter. For instance, changes in the contract may constitute a material departure from the original contract or substantially change the manner of payment, the way the contract is to be performed, or the time for performance so as to make the contract significantly more difficult or costly to complete. When this has occurred, the courts have relieved the surety from its obligation on the basis that the contract was not the one the surety originally underwrote and agreed to be bound by. For relief in such cases it is necessary to show that the contract change was made without the consent of the surety, and proof is required that the change in the contract substantially increased the risks of the surety and of the contractor. As a general rule of thumb, changes in the contract that increase the amount of the contract by more than 10 percent are considered to be significant.

A second consideration in obtaining written consent of the surety for a contract change is that the surety is not obligated to provide a bond for any additional or modified work unless the surety has expressly waived the right of notice. In this regard the performance bond in Figure 7.1 provides that the surety waives notice of any alteration or extension of time made by the owner. The payment bond in Figure 7.2, however, contains no such waiver clause. Some bond forms used by the federal government stipulate that the surety waives notice of all extensions or modifications to the contract. However, a number of these now also include a provision that limits the value of changes that can be made in a bonded contract without the consent of the surety to 10 percent of the amount of the contract.

.9 BOND PREMIUMS

For the purpose of computing contract bond premiums, construction contracts are divided into four classifications: A-I, A, B, and miscellaneous. Figure 7.3 contains a representative listing of these contract classifications.

The individual states must approve advisory rates submitted by surety companies and associations to state insurance commissions. These rates can vary somewhat with the surety company, and there are many deviated rates that are used. Such rates are adjusted up or down periodically to reflect loss experience. It is up to the contractor to determine from its surety firm the bond rates applicable to the specific project being priced. The premium rates shown in Figure 7.4 are for illustrative purposes only and serve to demonstrate representative contract bond rates and how premium costs for a given construction project are determined. The rates in Figure 7.4 are those used in conjunction with lump-sum and unit-price contracts where performance or performance and payment bonds are required. These rates include a warranty period of one year if required by the contract. If a longer period is required, an additional premium charge is made. The rates shown in Figure 7.4 apply to the total contract amount and include all subcontracted work. An example showing the application of these rates is given in Section 5.41.

When the work can reasonably be assigned to more than one classification, the classification requiring the higher premium rate controls. Neither the classification of the contract nor the premium rate can be altered by segmenting the work or by parties other than the contractor furnishing the materials. All separate contracts are assigned the same classification as the general contract. Bond premiums for cost-plus contracts are subject to some variation from the rates of fixed-sum contracts as contained in Figure 7.4. Premium rates for cost-plus contracts with guaranteed maximum amounts are the same as for fixed-sum contracts. Cost-plus-percentage-of-cost contracts have a premium charge of 60 percent of the fixed-sum rates, excluding the contractor's fee from the final contract amount. Cost-plus-fixed-fee contracts are assessed a premium of 30 percent of the fixed-sum rates, excluding the contractor's fee.

The premiums for contract bonds are payable in advance, and the bonds are customarily delivered to the owner at the time the contract is signed. This premium payment is subject to later adjustment based on the ultimate contract amount, reflecting final work quantities on unit-price contracts and including all change orders and contract adjustments.

7.10 THE SURETY

Essentially all contractors utilize the services of national corporate surety companies whose specialties are the writing of bid bonds and contract bonds for contractors. These firms are subject to public regulation in the same manner as are insurance companies. They operate under charters and file their schedules of premium rates with designated public authorities. Because the true worth of the bond is no greater than the surety's ability to pay, the owner reserves the right to approve the surety company and the form of bond. The federal government requires that all corporate sureties proposed for use on government projects be approved by the U.S. Treasury Department. This list of surety companies approved for federal projects can be a valuable reference for private owners when faced with the approval of a contractor-proposed surety. The Treasury list can be found

Classification			
A-1	A	B	Miscellaneous Contracts
Ash conveyors	Airfield grading	Air-conditioning	Ash removal
Boiler repairs	Airfield surfacing	Airport buildings	Bridges
Conveyors	Airfield runways	Aqueducts	Buildings, prefabricated
Doors	Aluminum siding	Buildings	Culverts
Fire alarms	Athletic fields	Canals	Demolition
Fire escapes	Beacons	Dams	Draying
Flagpoles	Ceilings, metal or acoustical tile	Dikes	Dredging
Floors, wood and composition	Coal storage	Docks	Garbage removal
Gas tanks	Curb and gutter	Electrical work	Grade eliminations
Generators	Curtain walls	Excavation	Hauling
Guardrails	Ducts, underground	Foundations	Highways
Ironwork, ornamental	Elevators	Gas piping	Maintenance
Kitchen equipment	Floodlights	Grain elevators	Overpasses
Lock gates	Glazing	Heating systems	Roads
Metal windows	Greenhouses	Incinerators	Shoring
Parking meters	Machinery	Jetties	Street paving
Pipelines, oil or gas	Millwork	Locks	Structural iron and steel
Police alarms	Murals	Masonry	Test borings
Radio towers	Parking areas	Piers	Timber cutting
Refrigerating plants	Parks	Piling	Underpasses
Scaffolding	Piping, high-pressure	Pipelines, water	Viaducts
Sidewalks	Playgrounds	Plants, power	
Signal systems, railroad	Riverbank protection	Plants, sewage-disposal	
Signs	Road medians	Plastering	
Stack rooms	Roofing	Plumbing	
Standpipes	Ski lifts	Seawalls	
Street lighting	Sprinkler systems	Sewers	
Tanks, gas	Stone, furnishing	Stone setting	
Thermostat equipment	Storage tanks, metal	Subways	
Towers, water	Tennis courts	Tunnels	
Track laying	Waterproofing	Waterworks	
Traffic control systems	Wind tunnels	Wells	
Weatherstripping		Wharves	
Window cleaning			

Figure 7.3 Construction contract classification for contract surety bond premium rate

Contract Price		Premium Rate per $1,000 of Contract Price for First 12 Months* (Subject to change without notice)			
		Class A-1	Class A	Class B	Misc.
First	$100,000	$ 9.40	$ 15.00	$ 25.00	$ 19.50
Next	$400,000	$ 7.20	$ 10.00	$ 15.00	$ 15.00
Next	$2,000,000	$ 6.00	$ 7.00	$ 10.00	$ 12.00
Next	$2,500,000	$ 5.00	$ 5.50	$ 7.50	$ 10.00
Next	$2,500,000	$ 4.50	$ 5.00	$ 7.00	$ 9.00
Over	$7,500,000	$ 4.00	$ 6.75	$ 6.50	$ 8.00

*For construction time in excess of 12 months or 366 calendar days, compute basic premium at above rates and increase this computation by 1% per month for each month over 12 months (disregarding a fraction of a month).

Figure 7.4 Premium rates for performance or performance and payment bonds. Lump-sum or unit-price contracts.

at *www.fms.treas.gov/c570/c570.html*. Another source of information in this regard is *A. M. Best Insurance Reports*, which provide financial ratings for insurance and surety companies.

Occasionally, on private work, the contract documents require that the contract bonds be obtained from a particular surety company. This requirement of specifying a particular surety usually means that the contractor must do business with an unfamiliar company. In this situation, obtaining the bond may turn out to be a lengthy and laborious process, requiring the submission of financial reports, a list of jobs in progress, an experience record, and other data of voluminous proportions that may be needed to establish the contractor's record and financial standing. The professional associations of contractors and architect-engineers oppose the practice of having the surety designated by the owner and support a policy of leaving the contractor free to obtain surety bonds from a company of its choice. However, the private owner is at liberty to follow whatever practice it wishes in this regard, and the contractor must either comply with its instructions or not bid. In this regard, there are a few states with statutes that prevent an owner from requiring a contractor to obtain contract bonds from a designated surety.

On large contracts, a single surety may seek protection for itself by enlisting other sureties to underwrite a portion of the contract. This is very much like reinsurance. The original surety remains completely responsible for guaranteeing the proper performance of the contract. If the bond is invoked, it is up to the original surety company to get its underwriting sureties to stand behind it in the completion of the contract.

In some instances the owner requires that the contract bonds be provided by cosureties, which means that two or more sureties divide the total contract obligation among themselves. On very large contracts this practice spreads the risk over the participating cosureties and correspondingly reduces the magnitude of the risk to which any one of them is exposed. This procedure also affords the owner a measurable degree of protection against possible financial default by a single surety. Occasionally it is necessary to have cosureties on large federal contracts because of limits established by the U.S. Treasury Department on the maximum amounts of single contract bonds that a given surety is authorized to execute.

7.11 INDEMNITY OF SURETY

A contract bond is not insurance for the general contractor and does not function for its protection. Under the bond, the surety indemnifies the owner against default by the contractor. However, the contractor in turn must indemnify the surety against any claim that may be brought against the surety because of the contractor's failure to perform in the prescribed manner. Legal fees incurred by the surety because of claims under the bond are also recoverable from the contractor. Before the surety will provide bond service, the contractor must first sign a formal application form or General Indemnity Agreement. This form is lengthy and contains a great deal of fine print. The net result, however, is that the contractor agrees to indemnify the surety and hold it harmless from expenses of every nature that the surety may sustain by reason of the invocation of the bond.

When the application is signed by an individual contractor or a partnership, each principal is obligated to the entire extent of his personal fortune. If a corporation makes application, only the corporation's assets are pledged. However, the corporate officers and company shareholders normally submit their personal contracts of indemnity to the surety in order to increase the firm's bonding capacity. Another means of providing needed financial capacity to an otherwise qualified firm is to obtain the personal guarantee or indemnity of a third-party financial backer. This is a case in which a person or entity having substantial financial resources contributes credit to the construction firm in return for a share of the profits.

Many contractors believe that once the surety has provided a bid bond, it is then obligated to issue payment and performance bonds for the same project if the contractor submits the successful bid. However, many indemnity agreements stipulate that the surety has no such duty. The agreement may provide that the surety can refuse to execute such bonds without incurring any liability and without affecting the mutual obligations of the parties with respect to other contract bonds issued under the agreement.

7.12 INVESTIGATION BY SURETY

Before a surety will furnish an unknown contracting firm with a bid bond or contract bond, a thorough program of investigation is carried out to establish the past record and current commitments of the company. To establish a bond relationship between a contractor and a surety is a time-consuming, costly, and laborious process for the contractor. The experience, character, reputation, financial standing, equipment, integrity, personal habits, and professional ability of the firm's owners and key personnel are carefully examined. A track record of satisfactorily completed projects, owner satisfaction, and prompt payment of financial obligations is essential. The surety checks to see that the contractor is well managed, has a history of meeting its financial obligations promptly, is reliable, deals fairly, and performs its work in a timely fashion. An attempt is made to identify the key employees, evaluate their experience, and determine whether the company has adequate estimating, construction, and administrative experience to accomplish the proposed construction work. The surety also past, are subject to study and analysis. The firm's bank credit is verified, together with its relations with its sources of credit and supply. Information must be given about the company's cost management and accounting systems. In short, a surety will issue bonds to a contractor only when the traditional "three C's" requirement is met: character, capacity, and capital. The information outlined here assists the underwriter in evaluating the ability of the contractor to complete work undertaken in accordance with contract terms and to meet the resulting financial obligations.

The providing of bonding services to a contractor is a highly individual matter. An exception to this general rule, however, can be found in the surety bond guarantee program that has been used by the Small Business Administration to assist qualified small businesses and minority-owned businesses to obtain construction bonds that they could not otherwise obtain. Under this program, the U.S. government guarantees to repay the participating sureties 90 percent of any loss caused by the default of a covered contractor on bonds up to $100,000 and 80 percent on bonds above that amount. The Small Business Administration (SBA) will guarantee bonds only for firms with three-year average annual revenues under $6 million and will bond projects worth up to $2 million. This program is called SBA Plan A.

Once a contractor has firmly established relations with a bonding company, the contractor's bonding capacity becomes reasonably well established, and future investigations by the surety underwriter are concerned with keeping the contractor's records current and investigating the individual bond requests as they are submitted. If the contractor's workload is well below its limit and contracts of the usual variety are proposed, a bond application is generally approved without delay. However, when the maximum bonding capacity is to be approached, or when an unusually large or completely new type of construction project is proposed, approval of the bond application may require a considerably longer period of time or may not be forthcoming at all.

When the contractor makes application for a bond for a new project, it will find that the surety is interested in many aspects of the work that is proposed. The following are the usual and most important subjects of investigation:

1. The essential characteristics of the project under consideration, including its size, type, and nature. Evaluation of the hazards of construction cannot proceed until the surety is apprised of the work. Included here are the identity of the owner and its ability to pay for the construction as it proceeds. The contractor must have adequate equipment, expertise, experience, and resources to do work of the type and size proposed.
2. The total amount of uncompleted work the contractor presently has on hand, of both the bonded and the unbonded variety. This must, of necessity, include work that has not yet been awarded. The obvious point of concern here is to prevent the contractor from becoming overextended with regard to working capital, equipment, and organization.
3. The adequacy of working capital and the availability of credit. The contractor can assist its own cause by keeping the surety fully informed as to its activities and supplied with up-to-date financial reports. This phase of investigation can often protect the contractor against taking on a project that is too big for it to handle.
4. The amount of money the contractor "left on the table," that is, the spread between

industry are such that a spread of more than 5 or 6 percent between the two lowest bidders can be the cause of some concern. The surety wishes to ensure that the contractor's estimating and bidding procedures are sound.

5. The largest contract amount of similar work the contractor has successfully completed in the past. Inexperience in a new field of construction has caused many contractor failures. The surety would like the contractor to stay with the kind of work in which it is most experienced. If the contractor wishes to change to another type, the surety will urge that the first steps be small ones until the contractor acquires the necessary experience. If the contractor is not properly equipped for the new work, it must be demonstrated to the surety how the equipment problems will be solved.
6. Terms of the contract and bonds to be required, details of how payment will be made to the contractor, retainage, time for completion, liquidated damages, and the nature of job warranties—these all influence the surety's appraisal of the contractor's ability to do the work.
7. The amount of work subcontracted and the qualifications of the subcontractors. The surety's concern here is that the prospective subcontractors possess the necessary organization, experience, and financial resources to carry out their portions of the work.

After each bonded project is completed, the surety sends to the owner a request for a final report on the contractor's performance. The owner is asked to submit to the surety a statement concerning the contractor's handling of the job, changes that were made in the work, and the final total contract amount. This figure is used as a basis for any terminal adjustment of the bond premium.

7.13 BONDING CAPACITY

A useful concept widely used by the construction industry is that of "bonding capacity" or "bonding line." These terms have no precise definition but refer to the maximum value of uncompleted work the surety will allow the contractor to have on hand at any one time. A contractor's bonding capacity is a function of its net worth and cash liquidity and can vary according to the volume of work on hand, accumulated retainage on current jobs, type of work involved, time durations of outstanding contracts, and other considerations. Bonding capacity, or the amount of surety credit that will be extended to a given contractor, is commonly obtained as a multiple of the contractor's net quick worth, perhaps augmented by the amount of money the contractor could realize by liquidating its fixed assets such as real estate and equipment. Net quick worth is obtained as quick assets minus current liabilities (see Section 9.10). Quick assets are those that are immediately convertible to cash. The multiple applied to net quick worth can vary substantially with the individual contractor and the field of construction involved. On building construction, where 75 to 80 percent of the contract is normally sublet, the factor may be 10 to 20 or more. With heavy construction, where few subcontracts are involved, large amounts of expensive equipment are required, and the work is often in isolated areas, the multiple is likely to be somewhat smaller. New contractors will have a smaller value than older and more experienced firms. When a surety grants a line of credit to the contractor, it may require that no one contract shall exceed a certain percentage of the total work on hand.

The difference between a contractor's bonding capacity and its current total of uncompleted work, both bonded and unbonded, is a measure of the additional work for which the surety will provide a bond. There are, of course, other factors involved, such as the type of new work being considered and the size of the project. In computing the current value of a contractor's uncompleted work, the surety may decide to deduct at least part of the value of the subcontracts that are bonded.

7.14 THE SURETY AGENT

The local representative of a surety company is the surety agent. This is the person with whom the contractor must deal directly in all matters concerning bid and contract bonds. There are many advantages to be gained by the contractor in selecting a thoroughly qualified and experienced agent who has bona fide surety company affiliations that enable him to act on behalf of the surety company he represents and to provide prompt bonding service. The surety agent is a very important member of the construction circle, who can contribute significantly to the success or failure of a contractor's business. The agent is a trained observer of the construction industry who has a detached point of view and whose advice is therefore particularly valuable to the contractor.

Most bonding agents are sincere and astute representatives of large corporate sureties whose businesses are solidly based on long experience and competent service. Given the discussion in the foregoing sections, it is easy to understand how the contractor may sometimes get the impression that the surety representative is unduly meddling in its affairs or is overly limiting its volume of work. In all fairness, however, the contractor should feel fortunate that the surety is interested and alert enough to be of assistance in helping avoid the many pitfalls associated with the management of a construction firm. The contractor must realize that both are working toward the common goal of a prosperous and successful contracting business. Some surety agents are, of course, more conservative than others. It is up to the contractor to select a bonding representative who is responsive to its needs within the limits of responsible and competent service.

The bid bonds and contract bonds that are provided to the contractor seldom, if ever, originate directly from the home office of the corporate surety. Rather, these documents are prepared by the local agent. In order to verify that the local representative is indeed an agent of the surety and is authorized to execute bond instruments that are binding on the surety company, it is customary that each construction surety bond include an appropriate power-of-attorney form, which is attached to the bond itself.

7.15 DEFAULT BY THE CONTRACTOR

Should the contractor default, the surety is required to perform in accordance with the terms of the bond. On contractor default, the surety may assume charge of the project and complete the contract or allow the owner to contract with another contractor. If the surety completes the contract, it is responsible for the total cost of completing the work, less the unpaid balance of the contract, even if the net cost exceeds the face amount of the bond. In the second case, the surety makes available to the owner funds sufficient to pay the cost of construction, less the balance of the contract price, but not to exceed the face amount of the bond. How the surety company elects to complete the contract is usually a matter for it to decide. There are several alternative courses of action, but a common one is for the original contractor to finish the job with the financial help of the surety and under the eye of a construction consultant hired by the surety. The surety may decide, however, to put the remaining work out for competitive bids and select a new contractor to take over, or a new contractor may be engaged on a cost-plus basis. The new contractor may contract with the surety or the owner. It should be noted here that upon default by the contractor, the surety can disclaim liability under the bond on the grounds that the owner acted improperly in terminating the contractor.

Contract bonds can offer the contractor a genuine advantage when its ability to proceed has been temporarily curtailed by legal or financial difficulties. If the financial condition of the contracting firm is basically sound, the surety may choose to help it get back on its feet and in business again. It may elect to advance the contractor credit in sufficient amount for the contractor to proceed with its work. If claims have tied up the contractor's capital, the surety may furnish bonds to discharge these claims, thereby enabling the contractor to proceed on its own. Such arrangements are made privately and occur more often than might be thought.

When the contractor defaults and the surety undertakes to complete the work, the surety becomes entitled to all of the remedies the owner has against the contractor under the contract. In addition, the surety is entitled to receive from the owner the balance of the contract price, which is defined in Figure 7.1 as "the total amount payable by Owner to Contractor under the Contract and any amendments thereto, less the amount properly paid by Owner to Contractor." Provisions of the governing statute apply to this matter when a statutory bond is used. The surety may also press any claims against the owner that the defaulting prime contractor may have had. Regardless of the bond wording, the surety often finds that it must compete with other claimants for the retainage withheld by the owner.

The surety also has another right in its relationship with the owner. If the owner defaults, for example, by not making progress payments, the contractor is released from liability under the contract. Because the responsibility of the surety to the owner is the same as that of the contractor to the owner, any act of the owner that releases the contractor from its contractual obligation also releases the surety.

An interesting situation regarding the protection afforded by contract bonds can arise on those construction projects where the owner has awarded work on its project to more than one prime contractor (see Section 1.19). On such projects, each prime contractor is normally required to provide the owner with a performance and a payment bond. When one prime contractor fails to perform in accordance with its contract, there is a question as to whether the defaulting contractor's surety is liable to the other prime contractors for interference or disruption to their work. The majority rule in this regard is that the surety of the defaulting contractor is not liable to the other prime contractors for additional costs that they may have suffered by reason of the disruption. Most jurisdictions deny that one prime contractor is a third-party beneficiary of the bonds provided by another prime contractor.

7.16 CONTRACT BONDS AND TYPE OF CONTRACT

The preceding sections have presented the basic workings of contract surety bonds. The contract (private work) or by governing statutes (public work), with 100 percent of the contract price now being the maximum possible value for each bond type. The details of such bonding are quite variable with the type of contract involved and can become very complex in some instances. A particular aspect of the construction process should be noted at this point. When the owner contracts with an architect-engineer for project design, the owner receives a professional service and no contract surety bond is involved. The owner's interests are protected, not by a surety bond, but by the architect-engineer's professional liability insurance (see Section 8.31).

The general bonding procedures normally utilized with the usual construction contract types are as follows.

Single Prime Contractor, Fixed-Price Contract. With this traditional contract arrangement, the single prime contractor provides the owner with the required performance and payment bonds. In the case of a lump-sum contract, the face values of the bonds are determined from the original contract amount. The premium paid is adjusted at project completion to reflect any change in contract price caused by change orders. With a unit-price contract, the same procedure is followed, with the bond amounts being based on the estimated total project cost. Here again, the bond premiums are adjusted at contract completion to reflect the final contract price.

Multiple Prime Contractors, Fixed-Price Contract. In this instance, each prime contractor provides the owner with bonds covering that contractor's site work and whose face values are based on that individual contractor's contract amount. In the usual instance, each of the prime contractors is free to use the services of its customary surety company.

Cost-Plus-Fee Contract. Here the contractor provides the owner with contract bonds whose face values are determined from the initial target price established for the work to be done by that contractor. As in other cases, the bond premium amount is finalized when the final contract price of the project has been determined.

Joint Venture. In a joint venture agreement, each participating contractor normally undertakes a specific amount or percentage of the total contract. Accordingly, each coventurer bonds its proportionate share of the contract price. The normal procedure is for the usual sureties of the various contractors to jointly underwrite the project and sign bonds as cosureties. Each surety provides its contractor's share of the contract bonds provided to the owner. In many cases, a working fund of 5 to 10 percent of the contract amount must be established by the joint venturers before the bonds are executed.

Construction Management. The construction manager (CM), as an agent of the owner, manages the project from its inception through the construction process. The CM is paid a professional fee of perhaps 3 or 4 percent of the total cost of construction for its managerial services. In so doing, the CM carries out many duties ordinarily performed by the architect-engineer, especially during the construction process. These functions of the CM are in the area of professional services, where contract bonds are not used. The CM also performs many management duties usually done by the general contractor. In the usual construction management arrange-the actual construction. The CM coordinates, schedules, and controls the work of these contractors.

In the standard agency form of CM, the construction manager does not provide contract surety bonds to the owner. Rather, these bonds are provided to the owner by each of the prime trade contractors. Protection for the owner from CM negligence is provided by professional liability insurance carried by the CM. The CM can be bonded, but the protection so afforded to the owner is small because the bond face amount is based on the CM fee contract, which is only a small percentage of the value of the entire project.

Design-Construct. It should be remembered that when the design-construct concept is used, the owner receives professional design services and project construction services from a single contracting party. Where design services are a part of the contract requirements, a surety firm will issue a bond for the entire project but may require a bond surcharge, for example, 120 percent of the normal bond premium. A complication here is that the cost of construction is often not accurately known at the time the design-construct contract is consummated and the bonds are procured. As a result, the initial face amounts of the contract bonds may be based on an initial, approximate cost of construction. The amounts of the bonds and their cost are adjusted at a later date when the design is complete and the final construction cost is determined.

7.17 SUBCONTRACT BONDS

An earlier discussion pointed out that the general contractor is responsible for the job performance of the subcontractors. In addition, it can also be held liable if a subcontractor does not pay for materials, labor, or sub-subcontracts pertaining to the project. Consequently, the general contractor, to protect itself against subcontractor debt and default, may require certain or all of them to provide performance and payment bonds. In this instance, the subcontractor is the principal and the prime contractor is the obligee. General contractors have found, to their dismay, however, that not every subcontract bond form nor every surety company provides them with the kind of financial protection desired. It is for this reason that many prime contractors require the use of their own subcontract bond forms. Otherwise, the contractor must reserve the right to approve the surety and bond form proposed for use by a subcontractor.

A factor of major importance to be emphasized at this point is that the bond serves in no way to replace honesty, integrity, and competence on the part of the subcontractor. Bond or no bond, an inferior subcontractor means trouble. Although the bond will afford the general contractor some measure of protection against financial loss directly attributable to a particular subcontract, it does not and cannot cover expenses caused by work stoppages, delays, and disruptions of the overall construction program that inevitably result from subcontractor default.

7.18 MAINTENANCE BONDS

Construction contracts provide, expressly or by implication, that the general contractor must project completion. A warranty period of one year is widely used, this being the period of time during which the contractor is required to remedy construction defects for which it is responsible at no cost to the owner. In case the contractor does not honor this responsibility, the owner is normally protected by the usual performance bond, which continues in effect during the one-year warranty period. If the contractor does not remedy defects, then the surety is required to do so.

However, one year may be too short a period for some parts of the work, and the owner may require positive protection against certain defects in the work beyond the usual one-year period. For example, the contract may require the contractor to guarantee the paving for 5 years or the roofing for 10 to 40 years. Manufacturer's or applicator's warranties are also sometimes required to guarantee the performance characteristics of machinery, processes, or materials.

The true value of a warranty is quite obviously only as good as the integrity of the firm standing behind it. In the event of breach of warranty, the warrantor becomes liable to the owner for damages. However, whether damages can actually be collected may be an entirely different matter. To protect the owner from breach of warranty by the contractor, subcontractor, or supplier, a surety bond called a maintenance bond or warranty bond is sometimes required by the construction contract. A maintenance bond, provided by the responsible party to the owner, binds the surety, if necessary, to correct defined defects in the contracted work that appear within a specified time after job completion. A common example of a maintenance bond is a roof bond, the terms of which guarantee the roof against defects of workmanship and materials for some specified period of time. A bond of this type is executed by a corporate surety, with the manufacturer of the roofing materials named as the principal. The owner must be careful in this regard because some roofing "bonds" are not bonds at all, but merely the unsupported warranty of the roofing contractor or manufacturer without surety.

When a maintenance bond covering some aspect of the work is provided to the owner, the owner must first look to the principal if defects materialize. If the principal refuses or is unable to remedy the situation, the owner can invoke the bond, and the surety must make good the warranty as guaranteed by the bond.

7.19 CONTRACT BOND ALTERNATIVES

If a prime contractor is not able to obtain the customary contract bonds from a commercial surety company, alternatives are occasionally used. Under the Miller Act, such bonds on federal construction projects can also be provided by personal or individual sureties or they can be in the form of U.S. bonds or notes, certified or cashier's checks, bank drafts, postal service money orders, or cash. A personal surety can be a company principal or stockholder who pledges personal assets or any other individual or group that agrees to answer for the debt or default of the contracting party. Such personal sureties must provide evidence of having a specified net worth or collateral sufficient to back up their surety obligation. The bonding statutes of many states and some private owners also permit prime contractors, and some prime contractors permit subcontractors, to use such alternatives to the usual commercial surety bonds.

The Office of Federal Procurement Policy now has a rule in effect that allows confederal construction contracts. This policy is designed to give more flexibility and contracting opportunities to smaller firms that may not be able to secure bonds. Such letters of credit are called guaranteed letters of credit, as distinguished from the usual commercial letters of credit used in sales transactions, and are backed by the contractor's funds, which are held by the bank. It should be noted that certain legal aspects of letters of credit differ greatly from the usual surety bonds.

With letters of credit, for example, the bank's obligation to pay is not conditioned on the mutual performance of construction contract terms by both the owner and contractor. As such, the bank is obligated to pay the owner if the owner presents the proper documentation, even if the owner has failed to perform as required by the construction contract. If the owner presents the documentation specified by the letter of credit to the issuing bank and if these documents conform to the letter of credit requirements, the bank will pay the owner. The bank will then seek reimbursement from its customer, the contractor, for the amount paid. However, a contractor who disputes whether it is in default can file suit to enjoin the bank from paying the owner on the letter of credit.

Letters of credit, unlike surety bonds, place the financial burden of a default dispute on the contractor rather than the owner. With a surety bond, if there is a dispute about whether a contractor is in default, the owner must wait until the dispute is resolved in its favor if it is to get its money from the surety. With a letter of credit, the owner gets its money immediately and the contractor must then sue the owner if it disputes the default. Contractors must be aware of the risks involved with letters of credit before using them.

7.20 MISCELLANEOUS SURETY BONDS

In addition to bid, performance, payment, subcontract, and maintenance bonds, the contractor occasionally finds it necessary or desirable to furnish or accept several other forms of surety bonds. The most important of these are the following:

Bonds to Release Retainage. Where a construction contract provides for the owner's retainage of a given percentage of the prime contractor's progress payments, the owner will sometimes make full payment to the contractor if the contractor will post a surety bond with the owner as obligee for the amount of the accumulated retainage involved.

Bonds to Discharge Liens or Claims. Persons who have not received payment for labor or materials supplied to a construction project are entitled to file a mechanic's lien against the property of a private owner or against moneys due and payable to the general contractor in the case of a public contract. Such actions can freeze capital needed by the contractor to conduct its operations. A surety bond in an amount fixed by an order of the court can be used to discharge a mechanic's lien. The bond functions as a financial guarantee to the owner and releases money that has been withheld from the contractor.

Bonds to Indemnify Owner against Liens. The contractor may be called upon to post a bond in advance that indemnifies the owner against any impairment of title or other damage that may be suffered by reason of liens or claims filed on its property. In this situation, a bond is required before any such liens are filed, rather than being used to discharge liens after they are filed in the way described in the previous paragraph.

Bonds to Protect Owners of Rented Equipment and Leased Property. During construction operations, the contractor may find it desirable to rent or lease equipment, parking lots, access roads, storage installations, and similar facilities. The owner of such property often requires the contractor to post a bond that guarantees proper maintenance and payment of rental charges, and indemnifies the owner against loss, damage, or excessive wear on the property.

Fidelity Bonds. The usual fidelity bond protects the employer against dishonest acts of an employee such as theft, forgery, or embezzlement. The employee covered by the bond is the principal, and the employer is the obligee. If the employer suffers a loss proven to have been caused by the employee, the surety will reimburse the employer up to the face value of the bond. This type of surety bond is more completely discussed in Section 8.18.

Judicial or Court Bonds. When the contractor is the plaintiff in a legal action, it sometimes is required to furnish security for court costs, possible judgments, and similar financial eventualities. Such security is often provided in the form of judicial or court bonds. This legal requirement is commonly applied when the contractor institutes court proceedings in a state or jurisdiction other than its own.

License Bond. Also known as a permit bond, this is a bond required by state law or municipal ordinance as a condition precedent to the granting of a contractor's license or permit. License bonds guarantee compliance with statutes or ordinances and make provision for payment to the obligee or members of the general public in the event that the licensee violates its legal or financial obligations. This topic is also discussed in Section 1.30.

Termite Bond. This form of bond is given by manufacturers or applicators of substances intended to prevent damage caused by termites for a specific period of time. The bond protects the property owner in the event that termite damage occurs after treatment is applied.

Subdivision Bond. This bond, given by a developer to a public body, guarantees construction of all necessary improvements and utilities.

Self-Insurers' Workers' Compensation Bond. This bond, given by a self-insured contractor to the state, guarantees payment of all statutory benefits to injured employees.

Union Wage Bond. This bond, given by a contractor to a union, guarantees that the contractor will pay union wages and will make proper payment of fringe benefits required by union contract.

QUESTIONS

1. What is the difference between a performance bond and a payment bond?
2. What is the difference between a statutory bond and a common law bond?
3. The Miller Act requires performance and payment bonds on all federal projects. How far down the subcontractor chain does the payment bond apply?
4. Why should the surety be notified of contract changes?

federal construction contracts. This policy is designed to give more flexibility and contracting opportunities to smaller firms that may not be able to secure bonds. Such letters of credit are called guaranteed letters of credit, as distinguished from the usual commercial letters of credit used in sales transactions, and are backed by the contractor's funds, which are held by the bank. It should be noted that certain legal aspects of letters of credit differ greatly from the usual surety bonds.

With letters of credit, for example, the bank's obligation to pay is not conditioned on the mutual performance of construction contract terms by both the owner and contractor. As such, the bank is obligated to pay the owner if the owner presents the proper documentation, even if the owner has failed to perform as required by the construction contract. If the owner presents the documentation specified by the letter of credit to the issuing bank and if these documents conform to the letter of credit requirements, the bank will pay the owner. The bank will then seek reimbursement from its customer, the contractor, for the amount paid. However, a contractor who disputes whether it is in default can file suit to enjoin the bank from paying the owner on the letter of credit.

Letters of credit, unlike surety bonds, place the financial burden of a default dispute on the contractor rather than the owner. With a surety bond, if there is a dispute about whether a contractor is in default, the owner must wait until the dispute is resolved in its favor if it is to get its money from the surety. With a letter of credit, the owner gets its money immediately and the contractor must then sue the owner if it disputes the default. Contractors must be aware of the risks involved with letters of credit before using them.

7.20 MISCELLANEOUS SURETY BONDS

In addition to bid, performance, payment, subcontract, and maintenance bonds, the contractor occasionally finds it necessary or desirable to furnish or accept several other forms of surety bonds. The most important of these are the following:

Bonds to Release Retainage. Where a construction contract provides for the owner's retainage of a given percentage of the prime contractor's progress payments, the owner will sometimes make full payment to the contractor if the contractor will post a surety bond with the owner as obligee for the amount of the accumulated retainage involved.

Bonds to Discharge Liens or Claims. Persons who have not received payment for labor or materials supplied to a construction project are entitled to file a mechanic's lien against the property of a private owner or against moneys due and payable to the general contractor in the case of a public contract. Such actions can freeze capital needed by the contractor to conduct its operations. A surety bond in an amount fixed by an order of the court can be used to discharge a mechanic's lien. The bond functions as a financial guarantee to the owner and releases money that has been withheld from the contractor.

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5. What are some of the factors that affect a contractor's bonding capacity?
6. What is the surety's obligation to the owner if the owner breaches the contract and the contractor stops work?
7. How are performance and payment bonds handled on joint venture construction projects?
8. If a performance bond covers the typical one year warranty period, why do some owners require a warranty or maintenance bond as well?
9. How does surety differ from insurance?