Surety Bond Tutorial by Lori Kieswetter

Contract Surety Bonds Defined

A bond issued by a surety bond company on behalf of a contractor, guaranteeing that the contractor will complete a contract as per the specifications (contract). The bond must match the descriptions and dates etc. shown on the contract it is guaranteeing.

.**Who benefits from a Contract Surety Bond?**

Your client is referred to as the Obligee in a bond. If the Principal (your company) cannot or will not perform, the Surety Company steps in and makes good on your obligations

Types of Bonds

This tutorial is only addressing contract surety bonds used in the construction industry but there is another type of surety bond called a Commercial Bond which is typically a license or permit bond.

Three Parties to a Contract Surety Bond

Principal

• This is your company – many contractors think this means them – as a shareholder of the company but in bonding terms – the principal is the term used for your company

• The company who will be expected to complete the contract they enter into with "the Obligee".

• It is the principal's obligation that is being guaranteed by the Surety Company.

Obligee

• The party to whom the bond is payable and with whom "the principal" has a contract.

• Often called the owner or your client.

Surety

• The entity giving the bond (the party that issues the bond).

• The Surety guarantees the performance of the obligations of the Principal under a contract

<u>Why Are Bonds Used?</u>

• Publicly Funded Projects

Most municipal, provincial and federal government bodies require contractors to post bonds to protect taxpayers' funds used to fund the project.

• Privately Funded Projects

More and more frequently bonds are requested on private projects. This trend is at least partially due to the financial institutions financing these projects seeking the comfort of a pre-qualified contractor and the security of a bonded project.

• Subtrade Bonding

General contractors benefit from bonding their subtrades both by the prequalification aspect and by the security on the contracts themselves by avoiding the financial impact of the subtrade failing to complete the contract.

<u>Advantages to the use of surety bonds:</u>

• Ability to provide bonds opens up job opportunities for you

• Levels playing field by ensuring only qualified contractors are bidding

• If there is a dispute on a job, the owner can simply cash your letter of credit whereas with a bond there is a process and investigation wherein the owner must prove his case before they can access funds. You have a chance to defend yourself first.

• The letter of credit it almost always more expensive and often it must be provided in an amount in excess of the contract price and remains in effect until substantial completion and sometimes beyond.

• A labour and material payment bond gives comfort to suppliers and subcontractors which usually result in better terms. They have no protection under a letter of credit.

<u>How are bonds different from insurance?</u>

An insurance policy assumes that there will be a loss, so the premium for an insurance policy is calculated to cover losses that may occur.

• A bond, on the other hand, is an extension of credit with the assumption there will be no loss. The bond premium covers only the underwriting expenses of the surety company.

• There are 2 parties to an insurance contract – the insured and the insurer. In a surety bond there are three parties. If there is a claim the principal (your company) will have to repay whatever loss the surety company experiences.

• Personal indemnities of shareholders and their spouses are also required and would be called upon in a loss situation. This means you are risking your house and your car and everything else you own

There are 3 stages of Construction

1 – PREQUALIFICATION STAGE

Often contractors are required to submit a prequalification package prior to a job being let for tender which may include a letter from their bonding company. At this stage there is no spec available to underwrite so the bonding company cannot commit to bonding.

You may also be required to provide your company's bonding limits. Surety facilities don't have limits – just guidelines but there is a lot of misinformation about surety bonds within the architectural and municipal industries. Depending on the your workload at the time this project progresses to Tender Stage it may or may not fit within those guidelines.

The letter provided would typically be worded as follows:

It is our understanding that «principal» wishes to be prequalified as a tenderer on the above captioned project, which we understand has an estimated contract value of $«estimate». We are the Surety Company for_____________, a highly valued client of _______________.   Should_______________ be successful in their submission, any request by our client for the requisite bonding support will be given our full consideration at such time. Our decision to extend the required suretyship will be subject to our normal underwriting requirements

2 - TENDER STAGE There are 2 contract surety bonds which could potentially be required at this stage

Agreement to Bond (sometimes called Surety's Consent)

• A guarantee by the surety that it will provide thePerformance and/or Labour and Material Payment Bond if "the principal" is the successful bidder.

• There is no standard wording and the document doesnot exist in the USA and has never been to court in Canada

• Many owners have developed their own forms. If those forms are not used you will likely be disqualified. Make sure you submit that form out of the spec along with the bond request.

• This document must have an original signature and company seal for the surety company so make sure you keep this in mind and allows plenty of time.

Bid Bond

• A guarantee from the Surety (bonding company) to the Obligee, the good faith of the Principal (you) when tendering

• If you fail to enter into a formal contract after the bid has been accepted, you are obliged to pay the Obligee either a fixed amount or the difference in money between your tender and the contract price the Obligee eventually enters into with someone else.

• In other words – if you make a mistake in your tender and don't want to take the job after all; the bonding company will have to pay the obligee the difference between your price and the price of the next qualified tender. Remember that with bonds; you will be held personally and corporately responsible to REPAY the bonding company that amount plus their expenses!

• The amount paid out in a claim cannot exceed the amount of the bid bond. • There is a time limit to the bid bond which corresponds to the time the tender is open for acceptance as per the spec. This time limit prevents an Obligee (owner) from deciding not the get the final bonds unless a problem occurs.

3 – CONTRACT STAGE

So you got the job!! Now you need to provide the “final bonds” or “contract bonds” and that might be just a performance bond or a performance bond and labour and material payment bond.

Performance Bond – CCDC

• to guarantee the Principal’s (your) completion of the contract as per the plans and specifications.

• If you fail then the Surety will do so as long as the Obligee has performed it’s obligations under that contract and satisfied any conditions in the Performance Bond.

• The Surety’s liability is limited to the amount of the bond.

• Claim can be made within one year of date of final payment due

• CCDC wording preferred

Once a default by the Principal (your company) has occurred the Surety can either a) finance the Principal (your company) if lack of money was the cause of the default

b) re-let the project to another contractor

c) let the Obligee (Owner) hire someone else to complete the project and reimburse them up to the limit of the bond

Labour and Material Payment Bond – CCDC

• Guarantees you pay all labour and material suppliers having direct contracts with you for labour and supplies for use on the project.

• The Obligee is designated as a trustee for those suppliers and subs but would not be able to claim under it themselves.

• If the principal (YOU) fails to pay, claimants can collect up to the penal sum of the bond. Payments under the bond will deplete the penal sum.

• Claimants required to give the Principal, Obligee and Surety notice by registered mail within 120 days of that date he last performed work or supplied material.

The surety industry feels that some of the obligations under the performance bond are carried into the labour and material payment bond. For this reason if you order only a labour and material payment bond and not a performance bond you will be charged for both since that is a better representation of the risk being accepted by you and your bonding company.

How Much do Bonds Cost?

(Remember you will have to build this cost into your tender price)

For Quickbond there is an annual fee of $600 and all tender bondswill cost $250 and will be payable online at time of order

With a traditional bond facility the annual fee will typically range from $3500 to $5000/year and will include the cost of tender bonds throughout the year

PLUS

Final Bonds – when you get the job

Please view the premium calculators on the website to compute your potential bond costs so you can build the correct amount into your tender price

- Annual Rate so if the job goes over one year, anything left after the first year will be computed again

- Based on CCDC forms. These are the Canadian standard forms. If the obligee provides their own forms there will be an additional cost and it is important to submit those forms with your tender and final contract bond requests to ensure the bonding company will write those bond forms.

- Will be adjusted if job value changes

- GST added to contract price before computing but premium not taxable

The Application Process

Go the website and click on Apply. If your bond needs are going to be limited to a contract price of less than $750,000 and you qualify for Quickbond – follow that link. The process can take as little as a few hours or as much as a few days depending on your submission and the complexity

If you wish to pursue a traditional bond facility follow that link. Allow 2 weeks for this process

The Decision

- There is no guarantee the process will result in approval and if you have paid the annual fee already and are not accepted that charge will be voided.

- Your submission will be approved only if we are confident you are qualified to perform the work program successfully and have the financial capacity to withstand the numerous risks involved in the construction business.

- If we feel we can bond your company remember each job is looked at on it’s own merits and there are no guarantees we can bond every job you want

Indemnity Agreement or Master Surety Agreement

• You will be asked to sign an indemnity agreement prior to any bonds being released

• Indemnity agreement/MSA obligates the named indemnitors to protect the surety from any loss or expense.

• Your company, and any related companies will be required to sign this document as well as all shareholders and their spouses. Again – this is a PERSONAL and CORPORATE obligation. You are potentially signing away your house and cottage and anything else you may own if a claim is made on one of your bonds.

There are other important conditions included as well that you should read and understand before committing to the bond process. We strongly recommend that you review this document with your lawyer so you fully understand the commitment you are making.

Why you should submit owner's forms provided in a spec at tender stage to your broker for approval

• If it's an onerous form the bonding company may be unwilling to write it. If that's the case and you didn't send it in at tender stage you won't be able to qualify your tender and if you are low bidder there will undoubtedly be trouble - your bid bond and/or agreement to bond could even be called.

• If it's just a moderately bad form there may be a surcharge and you need to know about that at tender stage so you can build the increase into your price.

Extended Warranties

Think of this...there is a roofing warranty of 20 years on a building you built. 10 years down the road you sell the company or close it down. You retire to the cottage in Muskoka. There is a roofing problem on that project. The roofer is long gone. You provided a bond. You signed an indemnity agreement to the bonding company saying you would pay them back for anything they pay out on your behalf. The owner of the project claims under the bond. The bonding company have no defense.

With an unbonded job it is only valid as long as the company is there to address it. Once it's bonded there is a bonding company and they have your personal indemnity.

Surcharges for Overruns/Underruns

When a surety company issues a premium invoice for a bond, that premium is based upon their total exposure to loss over time. This includes any increases in exposures and also to decreases.

• Periodically throughout a bonded job the Surety will send a Contract Status Report to the Obligee to track the job's status.

• If at the end of the job, there needs to be an adjustment to the premium charged then it will be done at this time

Quickbond

The recession of the mid 90`s resulted in heavy losses for the surety industry in Canada and the result was a change to the whole underwriting system. Contractors needed to be able to produce accurate inhouse financial information on a regular basis. Smaller contractors had a hard time complying and the increase in paper meant higher expense for the bonding company to keep a file open. The result was an increase in miminum requirements because the premium produced by those smaller companies simply didn`t pay for the costs incurred by the bonding company.

In 2009 I decided enough was enough. Joe`s Paving couldn`t bid on a $40,000 project for his local town hall because municipalities usually require bonds. It was never a case of Joe being unqualified; just that due to circumstances beyond his control – bonds were not available to him any longer. Being a part-time computer geek I started working on the development of a surety underwriting system to address the administrative costs to the surety company and so Quickbond was born.

The Quickbond program meets the needs of smaller contractors, weaker contractors, companies who rarely need bonds and companies who don't have the time required to set up a traditional facility. Now they can secure public contracts with confidence knowing they have the needed security and prequalification. It'sdesigned with limited underwriting requirements that make it easier for them to apply,and less administration background work and costs.

Program information

• Affordable – low annual fees means you pay for the documents you need

• Qualification is based on the financial strength of the owners, and the combined experience of the owners and the company

• Quick turnaround time, usually within 48 hours

• Affinity programs available for construction associations, offering a significant discount to members

• Single Limit is a maximum of $750,000 but be warnedyou may qualify for a lesser amount

In bonding there are 2 kinds of limits – one is single job which is self explanatory – it is the CONTRACT size we think you are technically and financially capable of performing. Then there is an aggregate limit which represents the maximum total you can have in bonded work on hand at any one time.

If your application is successful you will be given a single job limit and an aggregate limit

Project Requirements for Quickbond

- Size: Will be disclosed after your file has been underwritten
- Project location must be in same province
- Cannot subcontract more than 75 percent of the contract price.
- Bid results must be within 10 percent.
- Completion time must be 12 months or less.
- Maintenance/Warranty term must not exceed two years.
- Liquidated damages cannot exceed $1000 per day.
- Environmental work, curtainwall, subdivision agreements, completion guarantees, high tech

Traditional bond facilities will vary in size and project location but will likely be similar to the above.

Applicant Qualifications for Quickbond:

- An acceptable personal financial statement from at least 1 shareholder
- Credit scores of at least 600
- Total personal credit outstanding (excluding house mortgage) cannot exceed 50%
- indicated salary level (e.g., salary of $100,000 -- total debt cannot exceed $50,000).
- At least 5 years prior construction experience (foreman level or higher)
- Current company in business at least 12 months.
- No past or present surety bond claims
- At least 5 previously completed commercial projects
- Liability Insurance with a limit of at least $2,000,000
- An acceptable company credit score
- Traditional bond facilities will vary according to the bonding company and the result of the underwriting process

When ordering bonds………….(hit the white menu button at Quickbond.ca)

Stage of Construction

• Determine the stage of construction you are at.

• Remember there are 3 stages; Prequalification, Tender and Contract.

• In the menu in the portal you will see the 3 choices listed there.

Timing

• Bonds have to be signed sealed originals – by you and by the bonding company. Your broker has `power of attorney` which means they are legally able to sign and seal your bonds on behalf of the bonding company.

• Make sure you leave enough time for the bonds to be prepared (2 days or more) and enough time to have your bonds sent via courier or you will have to make arrangements to pick them up.

Accuracy

• If the person providing the information is guessing – one of two things are likely to happen. We will recognize it and this would affect our opinion of your knowledge and professionalism or worse yet – your bonds will be rejected. At tender stage this will mean your bid will be disqualified

When ordering a tender bond

- At tender stage you should request your bonds early and if the estimate gets adjusted closer to closing then you just have to call your broker and get permission to go ahead because bid bonds are typically issued in the amount of `TEN PERCENT OF ATTACHED TENDER` and you only have to permission to use those bonds if your final price is within 10% of the estimate you originally provided.
- Tick the boxes of the documents you need – make sure you check the spec carefully and remember that sometimes the agreement to bond is called the surety`s consent.
- Fill in your name – we need to know who to contact if we have questions
- Fill in your email for the same reason and note that unless this is filled in the request will be rejected
- Next is the Obligee`s FULL LEGAL NAME and their mailing address. If you don`t provide the correct name your bid will be disqualified
- The project description should include what you are doing and where and should not be more than a sentence or two
- Estimate – Please read the note at the top of this page
- Closing Date – this is the closing date of the tender and if you put in an incorrect date your bid will be disqualified.
- Next you have to tell us the amount of the bid bond if one is required. Again; an error here will result in your bid being disqualified
- All tender specs will stipulate how long you have to keep your offer (tender) open for acceptance. If there was no date then they could approach you in 10 years expecting you to do the job and at the price you originally quoted.
- Even if no agreement to bond is required, you still have to stipulate what the spec says about the final bonds which would be required if you are the successful bidder. This is part of the underwriting information which is required to approve your bond request
- Payment terms will be stipulated in the spec and would typically be monthly
- Maintenance – this is an important one!!!! CCDC includes a 12 month maintenance period but that can be changed in the spec and often is. If you don`t notice there is a 3 year maintenance term for instance, and are low bidder, your bonding company may not be willing to support such a maintenance term which would result in a claim on your bid bond and remember you are responsible for paying for any such claim.
- Start Date – what we are trying to find out is an estimate of when the job will start i.e. You might be tendering a job in the Fall but it won't start till the Spring. This is important when examining your work load
- Completion Date – same as above but we're also trying to determine how long the project is
- Next we're looking to find out what the liquidated damages and penalties are
- Design Build is a special situation and requires a discussion with your broker and a special supplementary bond application form
- Environmental risks likewise would require a conversation with your broker
- Many obligees include their own bonds forms in the spec. Once it's there you (and your bonding company) are obligated to use it. Some forms are so onerous your bonding company may not agree to that so if there are forms– send them with the request so you know before it's too late – that you have a problem.
- Further down the form you will see you have the opportunity to attach files to the bond request and this can be used for parts of the spec you are concerned about and wish to discuss or any bond forms that have been included. Even though this is tender stage, if a performance and/or labour and material payment bond are provided it is important to send them with your tender bond request.

When ordering a final bond

Make sure you check the spec to see if you are required to purchase the builders risk (all risk property policy). The CCDC contract states the General Contractor is required to do that so unless that requirement is removed in the supplementary conditions you should double check with the obligee but assume it is your responsibility.

The process is the same as it is for the bid bonds until you get down to the Bonds section

- The contract price should include any taxes so either include them or we will with your answer to the following question

- The contract date must be correct but if you have not been provided with the contract yet; the letter of intent date will suffice.

- Again everything follows the tender bond request process until you hit the “Other Bidders” question. The bonding company needs this information to see how much you left on the table. Anything over 10% will require some conversation with us