

A Guide to Construction Surety Bonds

Most construction contractors are familiar with the process of obtaining surety bonds, but they may not be aware of the legal relationships bonds establish the relationships among the principal (the contractor), the obligee (usually the owner) and the surety. Contractors' lawyers, on the other hand, are aware of the rights and the obligations of the principal, obligee, and surety, but they may lack practical knowledge about the process of obtaining bonds. This article is directed to both contractors and their lawyers. It explains in plain English just when construction surety bonds are required on federal, state, and private projects, and the bonding requirements contained in widely used contract forms, including federal government contracts, AIA contract forms, and the AGC subcontract form.

SOME SURETY BOND BASICS

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

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

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

TYPES OF SURETY BONDS

BID BONDS

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

PERFORMANCE BONDS

A performance bond guarantees the owner that the principal will complete the contract according to its terms including price and time. The owner is the obligee of a performance bond, and may sue the principal and the surety on the bond. If the principal defaults, or is terminated for default by the owner,

the owner may call upon the surety to complete the contract. Many performance bonds give the surety three choices: completing the contract itself through a completion contractor (taking up the contract); selecting a new contractor to contract directly with the owner; or allowing the owner to complete the work with the surety paying the costs. The penal sum of the performance bond usually is the amount of the prime construction contract, and often is increased

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

PAYMENT BONDS

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

SURETY BOND REQUIREMENTS ON FEDERAL PROJECTS

MILLER ACT AND FAR REQUIREMENTS

The Miller Act, [40 U.S.C. §§ 270a-270f](#), provides that all federal construction contracts performed in the United States must require the contractor to furnish a performance bond in an amount satisfactory to the contracting officer; a payment bond in a penal sum of up to \$2.5 million, and other surety bonds as well. In the Federal Acquisition Streamlining Act of 1994, Congress made the Miller Act inapplicable to contracts under \$100,000, and directed agencies to develop alternatives to surety bonds for contracts between \$25,000 and \$100,000. These statutory requirements are implemented in FAR part 28, bonds and insurance. You can get a good introduction to the language and purposes of surety bonds simply by reading [FAR part 28](#).

BID BONDS

A bid guarantee is required on federal projects whenever a performance bond and/or a payment bond is mandated. Bid guarantees usually are in the form of bid bonds, but on federal projects they may also be submitted as a postal money order, certified check, cashier’s check or an irrevocable letter of credit. A bid guarantee must be in an amount equal to at least twenty percent of the bid price; the maximum amount is \$3 million. The standard solicitation provision requiring bid guarantees says that if the contractor awarded the contract fails or refuses to execute all contractually required documents, the agency may terminate the contract for default. In such a case, the agency will make a demand on the bid bond or bid guarantee to offset the difference in price between that bid and the next lowest bid. Bid bonds and bid guarantees are returned to unsuccessful bidders after bids are opened; bid guarantees are returned to the successful bidder after all contractually required documents and bonds are executed.

PERFORMANCE BONDS

As amended by the FASA, the Miller Act requires payment bonds and performance bonds for all federal contracts over \$100,000. The penal amount of the performance bond is generally one hundred percent of the contract amount, and the penal sum is generally increased for each change order. The surety is entitled to receive information from the contracting officer concerning the progress of the work, payments, and estimated percentages of completion whenever it so requests in writing. The form of the Miller Act performance bond is set out at [FAR 53.301-25](#).

PAYMENT BONDS

Payment bonds are now required for all federal construction contracts over \$100,000. The penal amount of the payment bond is required to be a maximum of \$2.5 million where the contract price is more than \$5 million; for contracts less than \$5 million, the penal sum of the payment bond is to be forty to fifty percent of the contract price. Each solicitation must state that a payment bond and performance bond are required, the penal amount required for the bonds, and the deadline by which bonds must be submitted after contract award. The form for a Miller Act payment bond is at FAR 53.301-25-A. The bond form does not set out any time limitations for claims against the bond. However, the Miller Act provides that suits against a payment bond must be brought within one year after the date on which the last of the labor was performed or material was supplied. In addition, the Miller Act requires that second-tier subcontractors and others who do not have a direct contract with the prime contractor submit a written notice of their claim to the prime contractor with ninety days of the last date of their work on the project.

REQUIREMENTS FOR QUALIFIED SURETIES

Federal surety bond requirements may be met in three ways: surety bonds issued by an approved corporate surety; surety bonds issued by an individual surety who pledges certain defined types of assets; or by the contractor pledging assets directly. The third option is uncommon.

REQUIREMENTS FOR INDIVIDUAL SURETIES

Individuals may act as sureties to satisfy bonding requirements on federal projects if they have certain acceptable assets in the required amounts to support the bonds. Although federal agencies probably would prefer to deal only with approved corporate sureties, allowance for individual sureties may enhance competition by allowing awards to contractors that might not otherwise qualify to obtain bonds from an approved corporate surety.

To support bonds issued by individual sureties, agencies may only accept cash, readily marketable assets, or irrevocable letters of credit from a federally insured financial institution. Acceptable assets include cash, certificates of deposit or other cash equivalents; U.S. agency securities (valued at current market value); stocks and bonds traded on the New York, American and certain other exchanges, valued at ninety percent of their current 52-week low price; real property owned outright in fee simple, valued at one hundred percent of its current tax assessment value; and irrevocable letters of credit issued by federally insured financial institutions. Examples of unacceptable assets are also listed in the regulations. Unacceptable assets are those that may be difficult to liquidate (e.g., a life estate in real property); are of uncertain or greatly fluctuating value (e.g., jewelry); property commonly exempt from attachment under state laws (e.g., the individual surety's home); or commonly pledged to others (e.g., plant and equipment). An individual surety is required to submit an affidavit, in which the surety identifies the assets, the market value of the assets, and all encumbrances on the assets. The affidavit must also identify all other bonds issued by the individual surety within the last three years.

SURETY BOND REQUIREMENTS ON STATE PROJECTS-“LITTLE MILLER ACTS”

Statutes in all fifty states and the District of Columbia require performance and payment bonds for state government construction contracts. These state statutes often are called “Little Miller Acts” because many of them are modeled after the federal Miller Act. Useful information is available from the National Association of Surety Bond Producers. A good discussion of these Little Miller Acts is in Federal Publication’s CONSTRUCTION BRIEFING, *Little Miller Acts*. A fairly recent summary listing of these state statutes, along with citations, is in Bednar, *et al.*, CONSTRUCTION CONTRACTING, George Washington University (1991), at 1309a-1309r. We will not duplicate these discussions. Each state licenses sureties to issue bonds. The Little Miller Acts each require bonds by licensed sureties. You can identify sureties licensed in particular states by checking Circular 570 on the computer bulletin board and at Treasury’s World Wide Web site.

SURETY BOND REQUIREMENTS IN PRIVATE CONSTRUCTION PROJECTS

There obviously is a great variation among private construction owners and projects throughout the United States. Performance bonds and payment bonds are required by owners for most large construction projects. If the owner elects to require surety bonds, major issues for the owner to decide during project planning are:

WHAT BONDS SHOULD BE REQUIRED?

Performance bonds protect the owner from contractor default and delays, and these are important for commercial properties with fixed tenant availability dates. Payment bonds protect the property from mechanics’

liens, which might otherwise interfere with sale or refinancing of the property. Bid bonds, which generally address only the price-spread between the low and next to lowest bid price, serve a much narrower purpose. However, because of the expectations and requirements of the bid package, corporate sureties generally will issue bid bonds only to contractors who qualify for performance and payments bonds. Thus a requirement for a bid bond may help narrow the field of bidders to only those firms who can actually satisfy performance and payment bond requirements.

WHAT SURETY COMPANIES ARE ACCEPTABLE TO THE OWNER?

Since a surety bond essentially is a guarantee by the surety, the owner has an interest in deciding which sureties are acceptable. One means of identifying responsible sureties is to refer to the list of sureties approved in Circular 570.

WHO PAYS THE BOND PREMIUM?

Of course, the owner eventually pays all costs anticipated in the contractor’s bid, whether the project is fixed-price or is a cost-plus-fee arrangement. A private owner may want to provide separate reimbursement for the contractor’s bond premium cost when the bond is delivered to the owner. This procedure ensures that bonds actually are furnished.

SPECIFYING THE AMOUNT OF BONDS.

Premiums rise along with the penal sum of the bond, and the owner ultimately pays these costs in the contract price. Nonetheless, the owner has an interest in setting the bond penal sum high enough to provide the desired protection to the project. A fairly good guideline for setting penal sums is the FAR

requirement discussed hereinabove. The penal sum for the performance bond should be one hundred percent of the original contract price, and the penal sum should be increased for each change order. The payment bond should be fifty percent of the contract price up to some fairly large maximum penal sum.

SURETY BOND PROVISIONS OF STANDARD FORM CONTRACTS

Popular form contracts for private construction projects, those published by the American Institute of Architects (AIA) and the Associated General Contractors of America (AGC), leave bonding requirements to the choice of the parties. Thus these forms do not provide much guidance in deciding the issues we have identified. The current AIA General Conditions merely provide that the owner may require bonds elsewhere in the contract documents and that the contractor must furnish copies of the bonds upon request to any bond beneficiary (e.g., subcontractors or suppliers). AIA Document A-201 also provides that compensation for construction change directives ordered by the owner shall include bond premiums for the extra work. AIA's current owner-contractor agreement, AIA Document A-101, does not address surety bonds at all. AIA's contractor-subcontractor agreement, AIA Document A-401, addresses bonding requirements in article 7 by leaving a blank area for the parties to add any bonding requirements.

The current AGC Standard Form for Construction Subcontract, also endorsed by the American Subcontractors Association and the Associated Specialty Contractors, addresses surety bonds in article 5. Paragraph 5.1 provides that copies of the contractor's payment and performance bonds must be furnished to a subcontractor on request. Paragraph 5.2, "Subcontractor Bonds," provides that if bonds are required from the subcontractor, the subcontractor shall be reimbursed for surety bond premiums in the first progress payment. Performance and payment bonds must be in the full amount of the subcontract price, unless otherwise stated.

PROVISIONS OF STANDARD AIA BOND FORMS

Private construction contracts rarely require particular bond language. Rather, they usually require bonds in a specified amount with a surety acceptable to the owner, general contractor or other obligee. The AIA's bond forms, AIA Documents A-311 and A-312, are popular and instructive; thus their provisions merit a brief discussion.

AIA's performance bond form, AIA Document 311, provides that the surety waives notice of change orders and extensions of time. It says that the owner is the only person who can sue to enforce the performance bond, and that any such suit must be brought within two years from the date final payment is due under the contract. It also provides, if the owner declares the contractor in default, that the surety shall either complete the contract or, if the owner elects, shall obtain bids so that the owner may contract directly with a completion contractor with the surety providing funds sufficient for completion.

AIA's labor and material payment bond form, AIA Document A-311, is very similar to the Miller Act payment bond required for federal projects. It defines a "claimant" as a person or firm that has a direct contract with either the principal or a subcontractor to the principal. Thus in the typical case where the principal is the general contractor, claimants under AIA payment bonds are limited to subcontractors and suppliers who furnish labor and materials directly to the general contractor or directly to a subcontractor. Claimants are entitled to sue on the bond if they have not been paid within ninety days after the last day of their work on the contract. Claimants that do not have a direct contract with the principal (e.g., second-tier subcontractors) must give a written notice to the owner and the surety within ninety days of the last day of their work advising that the claimant has not been paid. Suits on the payment bond must be brought within one year of the principal's last day of work on the project. (This is different from bonds under the Miller Act, which requires that suits be filed within one year of the claimant's last day of work on the project.) Suits must be filed in a state or federal court for the county in which the project was located.

AIA's combination performance bond and payment bond, AIA Document A-312, is similar to the separate bonds described above, but this one adds some additional provisions. The performance bond contains requirements that the owner give the surety written notice before declaring the contractor in default, and provides for a meeting of the parties within fifteen days of that notice to discuss performance. The performance bond also gives the surety the option of having its principal complete the project, notwithstanding the default, if the owner consents. This probably would be done with financing or other assistance contributed by the surety. The payment bond in AIA Document A-312 requires that claimants that do not have a direct contract with the principal take action in set time frames. Such a claimant must give written notice to the principal that it has not been paid; wait thirty days for the principal's response, and then notify the surety in writing that it intends to make a claim on the bond. It also requires the surety, within forty-five days of such notice, to pay all undisputed amounts and to respond regarding any disputed amounts.

CONCLUSION

If the terminology of construction surety bonds is confusing at first, you may want to keep this guide as a reference. Surety bonds are required for most large construction projects in the United States and now more frequently they are required in other countries. Our next article will review the process of obtaining surety bonds, the choices contractors have among surety companies, and the agreements typically entered into between contractors and sureties when construction surety bonds are issued. Most construction contractors are familiar with the process of obtaining surety bonds, but they may not be aware of the legal relationships bonds establish the relationships among the principal (the contractor), the obligee (usually the owner) and the surety. Contractors' lawyers, on the other hand, are aware of the rights and the obligations of the principal, obligee, and surety, but they may lack practical knowledge about the process of obtaining bonds. This article is directed to both contractors and their lawyers. It explains in plain English just when construction surety bonds are required on federal, state, and private projects, and the bonding requirements contained in widely used contract forms, including federal government contracts, AIA contract forms, and the AGC subcontract form.