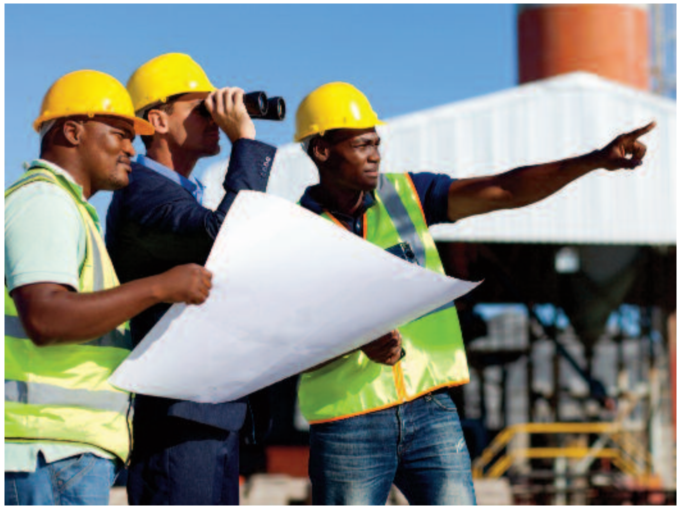

Claims

The manner in which the claims process is handled by sureties and banks also differs greatly.

Surety Bonds

- If the owner declares the contractor in default, the surety investigates.
- If the contractor defaults, the surety's options are to:
    - Finance the original contractor or provide support;
    - Take over responsibility for completion (up to the penal sum of the bond);
    - Tender a new contractor; or
    - Pay the penal sum of the bond.
- With payment bonds, the surety pays the rightful claims of certain subcontractors, laborers, and suppliers up to the penal sum of the bond.

Bank Letters of Credit

- The bank will pay on an LOC upon demand of the holder if made prior to the expiration date.
- There is no completion clause in an LOC. The task of administering completion of the contract is left to the owner.
- The owner must determine the validity of claims by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.

Surety Information Office (SIO)

www.sio.org
sio@sio.org

The Surety Information Office (SIO), formed in 1993, disseminates information about the benefits of contract and other forms of surety bonding in private and public construction. SIO, a virtual office, is supported by the National Association of Surety Bond Producers (NASBP), www.nasbp.org, and The Surety & Fidelity Association of America (SFAA), www.surety.org. For information on the benefits of surety bonds in construction and in other contexts, contact the Surety Information Office at sio@sio.org.

National Association of Surety Bond Producers (NASBP)

1140 19th St. NW, Suite 800
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(202) 686-3700
(202) 686-3656 Fax
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info@nasbp.org

The National Association of Surety Bond Producers (NASBP), founded in 1942, is the association of and resource for surety bond producers and allied professionals. NASBP producers specialize in providing surety bonds for construction contracts and other purposes to companies and individuals needing the assurance offered by surety bonds. NASBP producers engage in contract and commercial surety production throughout the U.S., Puerto Rico, Guam, and a number of countries. They have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.

The Surety & Fidelity Association of America (SFAA)

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The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

Surety Bonds or Bank Letters of Credit

Important Distinctions

Surety Bonds or Bank Letters of Credit

Important Distinctions

Construction project owners may use bank letters of credit (LOCs) to provide financial protection in the event of contractor default. However, completion of the construction project is the primary goal, and LOCs offer no such assurance. When it comes to limiting exposure to the inherent risks of construction, choosing the best form of risk management can make a big difference.

Contract surety bonds and LOCs provide similar financial protection; however, contract surety bonds have an edge when compared to LOCs and their effect on borrowing capacity, duration, coverage, cost, and claims and contractor prequalification.

Definitions

Surety Bonds

- A three-party agreement among the surety, the obligee (the project owner), and the principal (the contractor)
- A performance bond protects the owner from non-performance and financial exposures should the contractor default.
- A payment bond (a.k.a. labor bond and material bond) protects certain subcontractors, laborers, and material suppliers against non-payment by the contractor.

Bank Letters of Credit

- A bank LOC is a cash guarantee to the owner, who can call on the LOC on demand. The LOC converts to a payment to the owner and an interest-bearing loan for the contractor.
- The performance of the contract has no bearing on the bank's obligation to pay on the LOC.

	Surety Bond	Letter of Credit
Borrowing Capacity	Performance and payment bonds usually are issued on an unsecured basis and usually are provided on the construction company's financial strength, experience, and corporate and personal indemnity. The issuance of bonds **does not diminish the contractor's borrowing capacity** and may be viewed as a credit enhancement.	Specific liquid assets are pledged to secure bank LOCs. Bank LOCs **diminish the contractor's line of credit** and appear on the contractor's financial statement as a contingent liability. The contractor's cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected.
Prequalification	A surety company assesses the contractor's business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to verify that the contractor is capable of performing the contract. **The purpose is to avoid default.**	The banker examines the quality and liquidity of the collateral in case there is a demand on the LOC. If the banker is satisfied that the contractor can reimburse the bank if demand is made upon the LOC, there is no further prequalification.
Duration	Surety bonds remain in force **for the duration of the contract** plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.	An LOC usually is **date-specific**, generally for one year. LOCs may contain "evergreen" clauses for automatic renewal, with related fees.
How to Obtain	The contractor obtains the bond through a surety bond producer. A list of surety bond producers is available through the National Association of Surety Bond Producers (NASBP) at **www.nasbp.org**.	The contractor obtains the LOC through a banking or lending institution.
Cost	Generally 0.5% - 3% of the contract price (closer to 3% if the SBA Bond Guarantee Program is used). The bond is project-specific and covers the duration of the contract. The cost is included in the contractor's bid price.	Cost generally is 1% of the contract amount covered by the LOC (usually 5% - 10%)—e.g., if the LOC covers 10% of the contract, cost = 1% x (10% x contract amount) x years of contract. The cost is included in the contractor's bid.
Coverage	**Performance bond – 100% of the contract amount** for project completion **Payment bond – 100% of contract amount** protects certain subcontractors, laborers, and materials suppliers and protects private owner against liens. At least 10% coverage for maintenance of defects the first year after completion	The LOC may be obtained for any percentage of the contract, but 5% - 10% is typical. No protection/guarantee that subcontractors, laborers, and materials suppliers will be paid in the event of contractor default. They may file liens on private projects.