Q&A THE LEGAL BASICS OF SURETY BONDS

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What Is a Surety Bond and How Are the Parties Involved Defined?

A: A surety bond is a three-party agreement assuring the project owner (obligee) that the contractor (principal) will perform a contract in accordance with the contract documents. When a contractor requires its subcontractors to obtain bonds, the contractor is the *obligee* and the subcontractor is the *principal*.

Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk-transfer mechanisms regulated by state insurance departments.

Surety is designed to prevent a loss. The surety prequalifies the contractor based on financial strength and construction expertise. Because the bond is underwritten with little expectation of loss, the premium is primarily a fee for prequalification services.

What Are the Obligations of Each Party To the Bond?

A: Each of the parties has responsibilities related to each other party.

- The principal has the duty to the obligee to perform its contract. The obligee likewise owes a duty to the principal to uphold its end of the contract, including payment in accordance with the contract terms.
- The surety has a duty to the obligee to take action under the terms of the bond if the principal defaults under the contract. But the obligee has a duty to fulfill its bargain under the contract, again, including payment of any sums due under the contract, but this time to the surety that performs.
- The surety and the principal also have duties to each other. The surety has the duty to determine whether the principal is in default, and abide by the terms of the bond and any agreement of indemnity. The principal must cooperate with any investigation of an allegation of default and reimburse the surety for any losses incurred due to the default of the principal on its promise.

Which Laws Require Bonding?

A: The Miller Act of 1935 (originally enacted in 1893 as the Heard Act) mandates performance and payment bonds for all federal public works contracts in excess of $100,000 and payment protection, with payment bonds the preferred method for contracts in excess of $25,000. Also, almost all 50 states, the District of Columbia, Puerto Rico and most local jurisdictions have enacted similar legislation requiring surety bonds on public works over certain dollar amounts. These generally are referred to as "Little Miller Acts."

Many general contractors then require their subcontractors to obtain similar bonds to protect them from contractor default. While most states do not require bonds on private construction projects, many owners do require them to protect their project and assets.

What Are Attorney-in-Fact and Power of Attorney?

A: Most surety companies distribute surety bonds through the independent agency system. When a contractor or subcontractor needs a bond, the first step is to contact a surety bond producer, also known as an agent or broker. The producer generally receives power of attorney, i.e. the producer can sign bonds on behalf of the surety company for projects that fall within acceptable ranges established by the surety company. The attorney-in-fact is the holder of the power of attorney.

What Happens with a Claim on a Surety Bond?

A: When a claim is made on a bond, the surety must investigate the allegation of contractor default. The principal must cooperate with the surety and provide the information necessary for the surety to make a decision of whether it must perform under the bond. For example, the surety will examine the validity of the bond, whether notice of default was proper, whether there were material alterations or changes in the scope of the contract or gross overpayments, among other information.

If the surety determines that its obligations have not become void, the surety will identify its course of action, which may include:

- providing financial or technical assistance to the contractor;
- arranging for a replacement contractor;
- re-bidding the project for completion; or
- paying the penal sum of the bond.

What Are Rights of Subrogation?

A: Subrogation is the surety's right to enforce a third-party's rights against the principal. The surety must have made a payment to the third party in order to exercise subrogation rights. If the owner declares the contractor in default and the surety completes the contract, the surety has rights to undispersed contract funds. The principal must reimburse the surety for any losses incurred due to the principal's default.

If the surety determines that the allegation of default is wrong, the surety and principal stand together to oppose the obligee's claims. In addition to its subrogation rights, the surety also acquires protection against loss through the general indemnity agreement.

What Is a General Indemnity Agreement?

A: While a surety guarantees the performance of the principal to the obligee, the principal remains liable for its original obligation. If the surety must perform its duty to the obligee regarding the principal's contract, the principal is liable to reimburse the surety for that performance.

Because many contracting firms do not have the capital to assure this repayment, most surety companies require a general agreement of indemnity (GAI) to be signed not only by the firm, but by individuals willing to support the firm. This might be the owner(s) of the firm, the spouse of the owner, a parent corporation or merely other individuals willing to put themselves on the line due to their belief in the firm. Under the GAI (sometimes called simply an indemnity agreement), the principal company and all people or other companies that sign are liable to repay the surety for amounts it pays on the company's behalf.

What Legal Benefits Does a Bond Provide Subcontractors?

A: Sureties provide three basic bonds on a construction project: the bid bond, the performance bond and the payment bond. The bid bond ensures that the contractor will enter into the contract for the terms of its bid and supply the required additional bonds. The performance bond ensures the contractor will perform the contract, including paying its subcontractors and suppliers, and the payment bond provides a direct claim for subcontractors for unpaid invoices to the contractor. Each of these bonds has legal benefits to subcontractors.

If a subcontractor submits a proposal to a contractor to be included in a bid, the subcontractor wants to be sure that the contractor will enter into the contract if awarded. The bid bond encourages contractors to do just that in order to avoid having to repay losses to the surety from their failure to do so. The performance bond ensures that if the contractor defaults on the project someone else will be there with sufficient funds to see that the contractor's obligation to perform is completed. Subcontractors value having the performance continue with someone able to reaffirm the subcontracts without having to rebid the work under public bidding laws.

The payment bond has the most obvious legal value to subcontractors. If a contractor fails to pay for work properly performed by subcontractors, those subs have a direct claim against the surety for sums justly due. The sub does not have to obtain its money from the general, but can work directly with the surety. This direct right of claim is especially valuable on a public project where a sub cannot file a lien against the work.

How Do I Find an Attorney Specializing in Bonding?

A: If there is any question or doubt of a contractor's or the surety's rights or obligations, it may be advisable to consult an attorney knowledgeable of construction and surety. The American Bar Association (ABA) Trial Tort and Insurance Practice Section's Fidelity and Surety Law Committee includes lawyers who specialize in surety law. Many state bar associations also have surety committees or construction law committees.

For names of lawyers who have knowledge in your area, call the ABA, (312) 988-5607 and request the FLSC membership directory or the pages for a particular state, or call the state bar association for a reference.

Schubert is president of The Surety Association of America (SAA). For more information, contact SAA, information@surety.org, (202) 463-0600 or www.surety.org.