The English poet William Cowper acknowledged 200 years ago that a fool must, by chance, be correct now and then. A Polish proverb tells us that even a broken clock is right twice a day. Fool's luck and broken clocks are appropriate symbols for the banker who decides to issue a letter of credit for a contractor in lieu of the contractor securing a surety bond. Granted, the bank generates some income and the contractor faces less intrusion. But it's not worth it for banker or contractor, and this articles shows why.

Our Letters Are Not Their Bonds:

The Differences Between a Bank Letter of Credit and a Surety Bond

by Marla McIntyre and Dev Strischek

From time to time, bankers are asked to provide letters of credit (LC) for their clients. Because an LC essentially substitutes the bank's credit for that of the client, bankers typically issue them prudently. There are many logical reasons for issuing LCs, but substituting for a contractor surety bond is not one of them.

The Letter of Credit

The LC is an irrevocable commitment by the issuing bank to a third party beneficiary on behalf of a bank customer—the account party—to meet demands for payment. Payment is usually in the form of drafts after the beneficiary submits documents showing that the conditions set forth in the LC have been met.

Normally, there are 3 separate contracts associated with every LC:

1. The sales contract between buyer and seller.
2. The LC instrument, which is a contract between the seller and issuing bank.
3. The LC application or security agreement, which is a contract between the buyer and the issuing bank.

Types. Banks typically issue two types of letters of credit—the commercial letter of credit and the standby letter of credit. Sometimes referred to as *trade letter of credit*, the commercial LC is issued to ensure payment for a specific shipment of goods. A bank pays the commercial LC upon receipt of documents described in the LC, usually a draft and commercial documents. The commercial LC does not ensure that

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the goods purchased will be those invoiced and shipped, although the bank includes as many safeguards as possible to protect its customer. The LC is a contract in and of itself without any direct relationship to the underlying sales contract.

A bank issues a *standby* LC essentially to guarantee payment or performance by the account party. All LCs, including standby letters of credit, are extensions of credit and so must be evaluated as if the bank is actually advancing the funds. Some of the most common reasons for issuing standby LCs include:

- Liquidity and/or credit enhancement, e.g., commercial paper, private placements, "lower floaters," etc.
- Guaranty of payment of claims and/or operating expenses as part of a self-insurance program.
- Assurance of payment when due on open accounts, invoices, etc.
- Assurance of completion of real estate project site improvements, compliance with project-related agreements, etc.

The two most common types of standby LCs are the financial standby LC and the performance standby LC. The *financial standby* LC is issued to beneficiaries to ensure payment if the account party defaults in the payment of an outstanding loan or other form of debt. The *performance standby* LC is issued to beneficiaries to assure payment of a *specified amount* if the account party fails to perform a contractual nonfinancial obligation. The circumstances or conditions under which a bank would be asked to honor a standby LC are likely to be unfavorable, so banks generally do not issue them if account parties expect to use them as the primary means of payment. Understandably, banks avoid interpreting the circumstances or conditions and playing the role of referee between the beneficiary and the account party. After all, the bank's sole commitment is to honor the draft when properly presented. Instead, banks concentrate on drafting requirements explicitly and unambiguously for the form of documentation required, method of presentation, timing, etc.

The *performance standby* LC is issued to beneficiaries to assure payment of a *specified amount* if the account party fails to perform a contractual nonfinancial obligation.

A standby LC is not, technically speaking, a contract of guaranty or surety. Unlike a true contract of guaranty, the standby LC obligates the issuer to pay the beneficiary upon presentation of specified documents indicating a default rather than upon proof of the fact of default. A standby LC can be used in any situation where one party has an obligation or potential obligation to a second party, and the first party's promise to fulfill that obligation is not sufficient in the eyes of the second party.

Credit underwriting. Comparison of an LC with a direct loan underscores the difference in risk between the two. Once an event of default has occurred in a direct loan, the bank can choose to move against the borrower and its collateral. In contrast, if an LC applicant's financial condition begins to deteriorate, the bank may find that it cannot foreclose against collateral until the standby LC has been drawn upon by the beneficiary.

By that time, the borrower and its collateral are likely to have deteriorated even further. Accordingly, bank policies generally require that the applicant be sufficiently creditworthy to honor its reimbursement obligation over the entire term of the LC or to collateralize the LC. By and large, contractors do not qualify for unsecured credit commitments, so their LC requests probably have to be secured by liquid assets. However, excess liquidity is not

typical of contractors, either.

Banks usually employ standard LC documentation to ensure that the LC language is clear and unambiguous. Further, most banks prefer letters of credit to be secured by liquid assets—cash or properly margined, readily marketable securities—to offset the risk and to avoid the legal lending limits of unsecured standby LCs. So-called s*elf-renewing* or *automatically renewable* standby letters of credit present a higher level of risk and are generally prohibited unless collateralized by liquid assets. Similar collateral requirements often are required for a standby LC with a maturity greater than one year.

Now let's compare the attributes of the surety bond with the bank standby performance LC.

The Surety Bond

Definitional differences. A contract surety bond is a three-party agreement in which the surety guarantees to the owner (obligee) that the contractor (principal) is capable of performing the contract. In contrast, the bank LC is a cash guarantee to the owner who can call on the LC on demand without cause. Once called, the LC converts into a cash payment made to the owner and into an interest-bearing loan to be repaid by the contractor.

Contract performance determines the rights and obligations of the surety and the owner. A performance bond protects the owner from nonperformance and financial exposure if the contractor defaults on the contract. If the contractor is unable to perform, the surety is responsible for performance of the contract. A bank standby LC has no guarantee of project completion because the performance of the underlying contract has no bearing on the bank's obligation to pay on the LC. A conditional LC may require some burden of proof by the owner that the contractor has failed to perform before the bank will pay on the LC.

A surety payment bond, sometimes called a *labor and material bond*, protects subcontractors, laborers, and material suppliers if a contractor fails to pay them. Generally, these claimants may seek recovery directly from the surety company under the payment bond. The bond incidentally also protects the owner from subcontractor liens. A standby LC is normally used for open accounts and deals only with payment of documented sums within a stated time period. Most LCs are irrevocable, which means that both parties must agree to any changes to the LC, and the changes must be documented by an amendment signed by both parties.

Key Comparisons

Now let's compare and contrast the bank LC with the surety bond on several key points—borrowing capacity, duration, cost, coverage, and claims.

Borrowing capacity. Sureties generally extend performance and payment bonds on an unsecured basis. As mentioned earlier, most banks require liquid assets to collateralize LCs to contractors. The pledge of liquid assets diminishes contractor cash flow, especially in funding the initial stages of construction.

Duration. Surety bonds remain in force for the duration of the contract plus a maintenance period determined by the contract documents as well as the bond's terms and conditions. A bank LC is usually date specific, generally for one year, although with liquid collateral, the LC may be automatically renewable and subject to renewal fees.

Cost. The cost of a surety bond is a one-time charge and typically varies from 0.5% to 2% of the contract price. The premium usually covers a 100% performance bond, a 100% payment bond, plus a one-year maintenance period. A bank LC cost generally is 1% of a small percentage of the total contract price. For multi-year contracts, the LC may be renewed each year and the fee is charged each year.

Coverage. The surety bond's performance feature ensures completion of the project or payment up to the amount of the bond. The payment feature ensures payment to subcontractors, laborers, and materials suppliers while protecting owners against liens. The maintenance feature covers defects during the first year after completion if caused by the contractor.

A bank LC may be obtained for any percentage of the contract, but 5% to 10% of the contract price is typical. There is no protection or guarantee that subcontractors, laborers, and material suppliers will be paid if a contractor defaults, so their legal recourse is to file liens on the project. The owner will have to determine which claims are valid.

Claims. The surety company is obligated to both the owner and the contractor. If the contractor and owner disagree on contract performance issues and the owner declares the contractor in default, the surety must investigate the claim. The surety has several alternatives, depending on the bond form:

- Finance the original contractor or provide the support necessary to allow the contractor to finish the project.
- Find a new contractor to complete the contract.
- Assume the role of contractor and subcontract out the remaining work to be completed.
- Pay the penal sum of the bond.

Under the payment bond feature, the surety pays the rightful claims of subcontractors, laborers, and suppliers.

In contrast, the bank will pay on an LC upon demand by the holder. The holder or beneficiary must make a demand prior to the expiration date because no funds will be available after the expiration date, even for liabilities incurred before expiration. There is no obligation to complete the project. The task of administering the contract's completion is the owner's responsibility. In addition, the owner bears the burden of sorting through the payment claims of subcontractors, laborers, and materials suppliers. If the LC is insufficient to pay all the claims, the owner must decide which claims are to be paid and deal with the risk of liens on the project.

Summary

The bank that pursues standby LCs to contractors to increase fee income must evaluate this profit strategy closely. First, the construction industry's cash flow volatility rarely makes it a candidate for unsecured credit accommodations, so the prudent bank will require an LC to be collateralized with liquid collateral. However, contractors usually do not possess the excess liquidity to collateralize LCs, and tying up liquidity for collateral is likely to cause cash flow shortages in its construction activity. Second, the bet made on the amount of the LC is that it will be enough to cover shortfalls in performance or payment; if the owner loses the bet, the owner must cover the shortfalls, complete the project himself, and deal with possible liens from unpaid subcontractors, workers, or suppliers. Finally, the banker must deal with the reputational risk to itself of failed projects, bankrupt contractors, and unpaid trade creditors.

In contrast, the surety's standard performance and payment bond is usually an unsecured obligation that leaves the contractor's limited liquidity intact. Because of its unsecured nature, the surety's evaluation of the contractor's performance tends to be more exacting and rigorous than that of a bank secured by liquid collateral. Further, the bond's payment feature is more attractive to potential suppliers with potentially more attractive pricing of materials. Finally, it is in the surety's interest to get the job finished, whether that means financing the current contractor, finding another, or taking over the job itself. Meanwhile, subs, workers, and suppliers get paid for their labor and materials.

Bankers might take guidance from Ralph Waldo Emerson, who observed that the shoemaker makes a good shoe because he makes nothing else. The surety industry has been writing bonds for contractors for many years, and when a banker extends the full-service concept into such a specialized field, the banker runs the proverbial risk of being a jack-of-all-trades but master of none. The surety bond is simply a better instrument than a bank LC for underwriting construction risk on any given day. As Voltaire noted in his *Zadig*, "The opportunity for doing mischief is found a hundred times a day, and of doing good once in a year." Encouraging a contractor to get a surety bond instead of an LC is one way to do good. ❐

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