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# **THE CONTRACT SURETY BOND CLAIMS PROCESS**

Developed by the  
Associated General Contractors of America



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## OVERVIEW

### What is a surety bond?

A surety bond is a three-party contract. One party, the *surety*, promises, in accordance with the terms of a bond, to answer for the default of another party, the *principal*. The third party, the *obligee*, is protected by the bond. Typically, the principal and surety will promise to perform or pay the obligee up to a stated amount of money for damages if the principal fails to perform its contract obligations. A fourth party, the *surety bond producer* or “bonding agent,” is not actually a party to the bond, but is a resource to the other parties and often will have a facilitating role in a claims situation, especially because the bond producer often is the most familiar with the principal and its immediate situation.

When a prime contractor furnishes the bonds, the project owner is the obligee and the prime contractor is the principal. When the prime contractor requires the bonds from a subcontractor, the subcontractor is the principal and the prime contractor is the obligee.

### Do surety bonds function like traditional insurance policies?

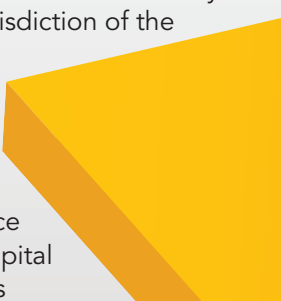
Although the surety is almost always an insurance company, the surety bond is not a typical insurance policy. The surety provides financial assurance of its principal's performance. The surety does not “assume” the primary obligation, but is secondarily liable. The principal remains primarily liable for performance of its contract. The principal must reimburse the surety for any loss the surety may suffer by virtue of the surety having extended surety credit to back the principal's performance. The obligee is protected by the bond against financial loss as a result of the principal's default. The bond does not, however, guarantee that disputes will not arise between the obligee and the principal.

A surety bond assures that the bond principal will perform its contract or pay what it owes to subcontractors and suppliers. If there is a legitimate dispute between the principal and obligee, the surety is not normally in a position to resolve it. That does not mean, however, that the surety will ignore a project disagreement. Disagreements can become disputes. Disputes can become breaches of contract. Breaches of contract can become defaults that justify termination of contracts. Everyone involved in the surety process is interested in avoiding that progression.

### Do principals and obligees need to verify that the sureties providing bonds for projects are licensed to do business, and that the bonds themselves are authentic?

Sometimes contractors are principals. Sometimes they are obligees. And sometimes they are both. Whatever the case, it remains important for contractors to look into the sureties with whom they are dealing, and to ensure that the bonds provided for a project are authentic. A financially unsound surety cannot add to the credit standing of its principal or provide its obligee with the protection that the latter expects. Fraudulently issued bonds can leave principals in breach of their contracts and leave obligees without any protection of any kind.

As a threshold matter, a contractor should check with its state insurance department to ensure that the surety is admitted to do business in the jurisdiction of the project. With few exceptions, a surety must possess a certificate of authority from the insurance commissioner in each state in which it issues bonds. The certificate provides some assurance that the surety meets minimum capital requirements and periodically files





financial reports with the state. The National Association of Insurance Commissioners has posted a list of all of the states' insurance departments on the Internet at [www.naic.org/state\\_web\\_map.htm](http://www.naic.org/state_web_map.htm).

The federal government also requires all corporate sureties providing bonds for its projects to possess a certificate of authority from the U.S. Treasury Department. The federal government has posted a list of the sureties that have such a certificate (and are therefore approved to provide bonds for federal projects) on the Internet at [www.fms.treas.gov/c570/index.html](http://www.fms.treas.gov/c570/index.html) under "Sureties Listing." The list is commonly known as "Circular 570" or the "T-List," and it includes the address and phone number for each surety and each state in which the surety is licensed to operate.

In addition to this public information, contractors should request their bond producers to provide insight into the reputation, financial strength, and claims handling practices of specific sureties. Contractors may also want to contact financial rating services, such as A.M. Best Company.

Whenever presented with a bond, a contractor should also contact the surety that apparently issued the bond to verify that it is duly authorized. In the process, the contractor can also ensure that it has properly identified the surety. It is unfortunate, but true, that some small number of disreputable individuals and firms have taken names that are deceptively similar to reputable sureties, hoping to benefit from the resulting confusion in the marketplace. Circular 570 provides a specific contact number for each surety that it lists. In addition, the Surety & Fidelity Association of America has surety contact information in its SFAA Bond Obligor Guide, which contractors can find on the Internet at [www.surety.org/?page=VerifyYourBond](http://www.surety.org/?page=VerifyYourBond).

### **Are there different types of surety bonds?**

There are three primary types of contract bonds: bid bonds, performance bonds, and payment bonds. A *bid bond* provides financial protection to an obligee if a bidder is awarded a contract pursuant to the bid documents, but fails to sign the contract and provide any required performance and payment bonds. The bid bond also helps to screen out unqualified bidders and is necessary to the process of competitive bidding.

A *performance bond* provides assurance that the obligee will be protected if the principal fails to perform the bonded contract. If the obligee declares the principal in default and terminates the contract, it can call on the surety to meet the surety's obligations under the bond. Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.

A *Payment Bond* provides assurance that certain **laborers** and material suppliers that furnish services, **labor**, and materials for use on the bonded contract will be paid. Payment bonds are provided primarily for the benefit of the principal's suppliers and subcontractors on a project, providing them with a remedy in the event of non-payment. With that benefit, however, come certain obligations to notify the surety or the contractor of non-payment in a timely manner. In many states, the time periods for sending notices or enforcing claims are set by state laws. There are also laws governing payment bond claims on federal projects.

### **Is it important to review and be familiar with surety bond language?**

Although most bond forms are simple documents, often no more than two pages in length, the rights and liabilities of all of the parties to a surety bond—the principal, surety, and obligee—can be quite complex. With surety bonds, as with other contracts, it is critical to read the bond to determine the respective rights and obligations of the parties.

This publication is only a starting place to understand the bond claims process. Whether you are a principal, an obligee, or a subcontractor or supplier with a claim, there is simply no substitute for sound professional advice by a qualified attorney or surety professional.

### **Is each claim or default situation unique?**

None of the parties enters into contracts with the expectation of a default. When one occurs, or is claimed to have occurred, there has been a failure somewhere. This is so even if it is only a failure in communication or expectations and not a true default. By the time an obligee makes the difficult decision to terminate a contractor, the principal and obligee are often frustrated, distrusting, and unhappy with each other. The unique facts and circumstances of the project, the personalities of the parties involved, the exact terms of the bonds, and differing state laws on bonds and contracts mean that no two default situations are ever quite the same. Hard and fast rules or guidelines as to any party's expectations are difficult, if not impossible, to establish.

# PERFORMANCE DEFAULTS

## Can sureties help avoid performance defaults in the first place?


There are innumerable instances in which sureties have mitigated performance problems so that such problems did not rise to the level of contract defaults. To that end, sureties offer their principals assistance and benefits to ensure their completion of bonded obligations, including accounting and technical assistance. One of these unseen benefits is where a surety takes control of contract funds and provides additional capital to a struggling contractor to avoid a default. This may happen without the obligee even knowing that a problem existed and happens more often than many obligees realize.

## What should an obligee expect in a performance bond default situation?

A performance bond provides assurance that the obligee will be protected if the principal fails to perform a bonded contract. It is a financial "safety net." The performance bond does not guarantee that there will be no disputes, disagreements, or delays. While bonded contractors are pre-qualified, the bonding process does not guarantee peace and harmony when disputes arise. An obligee should not expect otherwise.

## What is the general timing of the surety's response?

The most frequent complaint by obligees in default situations is the speed at which decisions are made and action taken. Most contracting parties are reluctant or slow to declare a default. They often provide opportunities to the principal to cure a perceived default. They may tolerate imperfect or slow performance for extended periods of time while the other party promises improvement. By the time a default is actually declared, the obligee may be at wit's end. Perfectly rational general contractors that would never think of giving a mechanical subcontractor less than two



weeks to properly price and scope its work for a bid in a very controlled situation find themselves demanding that the surety mobilize in the midst of controversy, properly assess the status of the work, present a plan for the completion of a half-complete mechanical system, and commence productive work in less time. It simply cannot happen.

Only in rare circumstances is a default crystal clear. The bonded contractor is in bankruptcy and has admitted that it cannot fulfill its obligations. It may have agreed that the obligee has not contributed to the default. In such a circumstance, the surety should be able to act relatively quickly. Short of that, the surety will perform an investigation and determine its options. Any unilateral action by the surety to blindly heed the demands of either the obligee or the principal may result in perceived unfairness to one or both. In all instances, an obligee should expect a prompt response from the surety to the notice of declaration of default, communication while the investigation takes place, and a decision within a reasonable period of time.

## How important is early communication in addressing performance defaults?

The surety may ultimately be liable for the delay, but it has very limited ability to avoid the time impact of a default, no matter how good its intentions. Early communication with the surety vastly improves the surety claims process. A surety's ability to limit the impact of a default is directly related to whether or not the obligee has kept the surety informed of the status of the project, how quickly the obligee provides needed information to the surety when a default is declared, and the level of cooperation of both the principal and the obligee.

Some performance bonds may require a meeting among the obligee, principal, and surety prior to any declaration of default. Even if the bond does not require it, such a meeting is almost always useful. If there are such serious problems on the job that the obligee is considering a termination for default, the surety should want to know about it, and the obligee should want to involve the surety. Surety claims professionals are experienced in dealing with troubled projects, and the surety can often help avoid a default termination. It is at this initial meeting stage that the professional bond producer may be of great value to the process, as a confidant of both the surety and the principal.

If the bonded contractor is otherwise competent but does not have the capital necessary to complete the project, the surety may advance funds to finance completion by the principal. If that occurs, the obligee should be willing to make future payments as joint checks or as otherwise requested by the surety to assure that funds from the bonded contract are used only to pay obligations on the contract. The surety and the obligee have a common interest in seeing that contract funds are not diverted from a bonded project.



## What is the importance of formal termination of the principal's contract?

Two contractors cannot perform the same work at the same time. That is one reason most bond forms make the formal termination of the principal's contract a condition precedent to the surety's performance obligations.

Although sureties will insist that they cannot assume responsibility for performance unless the contractor is terminated, that does not mean they cannot and should not investigate the problems and consider alternatives prior to the termination. Early warning and cooperation are always helpful in minimizing everyone's losses.

If the obligee does decide to terminate the bonded contract and call upon the surety, the surety and the obligee generally have a number of options. Some bond forms spell out the options and make them part of the agreement. Some forms are silent on the subject of performance default options. Whether or not the bond spells out the options, or even if the options in the bond are limited, it always makes sense to explore all possible options for the resolution of disputes and the completion of bonded work.

## What are typical options available to the surety to remedy a performance default?

### *Tender Option*

One option is for the surety and the obligee to agree on a replacement contractor to complete the bonded work. This is often referred to as the surety's "tender option," because the surety "tenders" a new contractor to the obligee. If the replacement contractor's price exceeds the balance remaining in the bonded contract, the surety will fund the excess either by paying the replacement contractor as the work proceeds or by paying the obligee the amount of the overrun in return for a release. Under normal circumstances, the obligee and the surety will insist that the replacement contractor provide new bonds to guarantee its performance of the completion work. One advantage of this tender option is that the obligee can deal directly with the new contractor in administering the project.

### *Takeover Option*

A second option in the event of a default is for the surety itself to assume or "take over" responsibility for completing the remaining work. The surety would then hire construction professionals to manage and perform the completion. Although it is possible on a given job that a consultant or construction manager is all that is needed and the original subcontractors can perform the completion work, it is more common for the surety to hire

a completion contractor. The delivery method by which the work is completed will depend largely on the status of completion. A surety is more likely to elect this option for a job that is well along in performance.

If this second takeover option is used, the surety and the obligee often will enter into a "Takeover Agreement" spelling out their respective rights and obligations in connection with completion of the work. Although some have suggested that a Takeover Agreement is unnecessary, and that the surety should just show up and commence work, the better practice is to avoid misunderstandings and disputes later on by entering into a definitive written agreement.

### *Allow Obligee to Complete*

Another option following the default of the principal is for the surety to elect to not be involved in the completion work. This is usually an available option, regardless of the options spelled out in the bond. A surety that elects this option should advise the obligee promptly so that job completion is not unduly delayed. In this scenario, the surety remains exposed to liability for the costs to complete in excess of the remaining contract balance up to the penal sum of the bond.

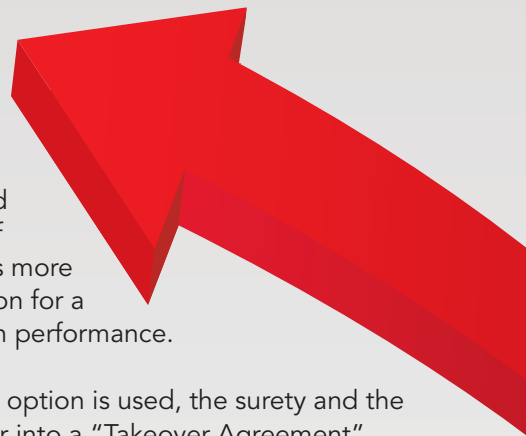
Because this option leaves the surety with little or no control over the manner in which the work will be completed, it is not one often exercised by sureties. The most common situation in which the surety elects this option is if the job is close to completion and the obligee's plan for finishing the work is reasonable.

### *Denial of Claim*

If the surety, after its investigation, concludes that it has no liability under its bond, the surety may deny the claim and decline to perform.

### *Other Options*

Other options are limited only by the facts, the resources, and the creativity of the parties involved. These range from up-front cash settlements, to continued performance by the original contractor, possibly with additional monitoring, to various combinations of all of the available options. The obligee or the surety that insists that the default be remedied only in one way may often miss opportunities for savings in time, money, and heartache.



### **Is there a common interest shared among the parties to the performance bond?**

Even if there is a dispute over the propriety of the termination, all three parties to the bond have a common interest in seeing the work is promptly completed with as little cost and delay as possible. The fact that they disagree on the existence of a default does not necessarily prevent cooperation to complete the work. In an appropriate situation, for example, the surety can take over the work or tender a replacement contractor under a "reservation of rights." Under such an arrangement, the parties agree that if it is eventually determined that the default was wrongful, the obligee will pay the surety any excess costs. If the obligee is certain the default was proper, it runs no risk in making such an agreement with the surety.

## **PAYMENT CLAIMS**

### **Can the surety help avoid payment claims in the first instance?**

A surety should be made aware of any perceived project problems, including allegations of unpaid subcontractors and suppliers, so the surety can consult with the principal and ascertain whether the principal is keeping up with its payment obligations. If, for example, the surety finds that the principal is experiencing cash flow problems, leading, in turn, to slow or nonpayment of downstream subcontractors and suppliers, the surety can assess what steps to take, if any, to avoid further issues, including whether it will provide the principal with additional financing. In such manner, the surety can avoid additional payment claims and the possible imposition of liens against the project.

### **What should a payment bond claimant expect?**

A Payment Bond, sometimes called a "**Labor** and Material Payment Bond," is required by the obligee, but the bond is primarily for the benefit of the principal's suppliers and subcontractors. The bond obligates the principal, whether a contractor or subcontractor, to pay for labor and material furnished for use in performance of the bonded contract. The claimants are usually limited to subcontractors or suppliers to the bond principal or sub-subcontractors or suppliers to a subcontractor of the principal.

### **Is strict observance of notice and time requirements important to claimants?**

Claims against payment bonds are sometimes made against financially sound principals that have breached no obligation to the claimant. This occurs when a claimant has no contract with the principal but has not been paid by the principal's subcontractor or sub-subcontractor. The fact that the principal has paid its subcontractor is not normally a defense to a claim by an unpaid sub-subcontractor or supplier to the subcontractor. The bond principal, therefore, can find that it has to pay twice for the same work – once to the subcontractor and again to the subcontractor's sub-subcontractor or supplier. To give the principal an opportunity to protect itself from such double liability, most bonds require that a claimant that does not have a contract with the principal give the principal or the surety, or both, written notice of its claim within a relatively short time after the claimant furnished the labor or material for which claim is made. In some cases, the time period runs from the date of the last of the claimant's work. In others, it may run from the date of each delivery. The terms of the bond and any statutes governing the bond will control those deadlines. Courts strictly enforce such notice requirements. Therefore, a prudent potential claimant should take any necessary steps to understand its rights, obligations and all applicable timeframes. Some subcontractors and suppliers request copies of bonds before they make any deliveries, so that they are aware of any notice requirements.

### **Can a claimant facilitate the surety's evaluation of the payment claim?**

A payment bond claimant already may consider its account "past due" by the time it turns to the surety. Just like the performance bond obligee that believes it has already lost too much time accommodating the principal, the payment bond claimant is anxious for payment. The surety, on the other hand, may have no direct involvement in the project and no prior knowledge of the claim. The best way for a claimant to speed up the claim process is to write the surety, explain the claim, submit full and complete documentation supporting the amount owed, and ask for any forms or affidavits the surety needs to evaluate the claim. The surety will typically want to receive copies of any subcontract or purchase order under which the work was performed, invoices to the principal or the principal's subcontractor, a record of payments and how they were allocated, and delivery slips or other documents showing delivery of material to the job site.



The surety will want to obtain its principal's position on the claim, and if the claimant has correspondence or other documents from the principal acknowledging that the claim is owed, it should submit them with the initial claim letter. It should also provide any supporting material the surety requests and follow up to see if anything else is required. The more documentation the claimant can provide early in the process, the faster the surety can examine the claim and respond.

### **What should claimants expect from the payment bond claims process?**

The surety typically will acknowledge receipt of the claim and ask for any missing information. The surety will also contact the principal and ask for its position. A bond claim is not a way to pressure the principal to pay something it legitimately believes is not owed. A bond claim is not a way to nudge a principal into more timely payment. A payment bond claim is a safety net against a credit decision gone wrong.

The vast majority of payment bond claims are resolved amicably and promptly, usually by the principal. When the principal has clearly defaulted in its payment obligations, the surety should be expected to promptly pay those claimants that have established the validity of the debt and have met the notice requirements of the bond. The surety should not be expected to pay claims without regard to their merits, but it should be expected to respond to claims promptly and, if it denies a claim, to explain its reasons.

### **How important is communication throughout the claims process?**

During the course of a claim, which often is a time when communication already may be strained, there is a heightened need for effective communication by all parties. This factor cannot be overemphasized.

Each party to the process should communicate openly and candidly with the other parties. The timeliness of the surety's response depends on it. Most defaults do not occur overnight. They are the product of a number of causes over an extended period of time. They can seldom be remedied overnight. Any party to the problem can greatly increase the likelihood of a good result by communicating promptly, factually, and objectively.

### **Are prolonged disputes counter to the common interests of all the parties?**

The bond principal, the obligee or the claimant, the surety, and the principal's bond producer have many common interests in the prompt and fair resolution of bond claims. No one in the construction process benefits from prolonged and needless disputes. If the obligee or other claimant embraces reasonable expectations, maintains open communication lines, and is committed to acting responsibly, including furnishing requested claims information promptly, most claims can be amicably and successfully resolved.

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For additional materials and information on surety bonding, contact the Surety Information Office (SIO) at Email: [sio@sio.org](mailto:sio@sio.org) or Web Site: [www.sio.org](http://www.sio.org).

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