The Surety Safeguard for Third Party Vendor Contracts

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The Surety Safeguard

Surety bonds have been utilized for decades for government construction contracts and in other federal procurement contexts. During the current economic climate and various government bailouts, you do not hear of such funds being utilized for uncompleted public works projects. That's because taxpayers are protected against virtually all losses caused by contractor failure through the use of surety bonds.

Surety bond companies provide the resources necessary to complete contracts in the event of default. Obtained by contractors from surety bond companies, surety bonds transfer the risk of failure or non-performance to the surety bond company.

When a government entity awards a contract to the lowest bidder, it knows that the surety bond company stands behind the contractor's promise to complete the job according to the owner's specifications and terms of the contract.

As more public agencies have tightening budgets, many have turned to private companies as third party vendors to support contracts for outsourced help as a means to save money. As the work being performed uses public funds such funds are put at risk based on the merit of the third party contractor performing the work. Thus, some Public agencies have turned to Surety Bonds as a means of protection to safeguard tax payer money.

A Long History

The idea behind surety bonding is simple and direct. One person guarantees to another that a third person will perform.

This concept isn't new. The earliest recorded attempt to form a company to engage in the surety business was in 1720. And in 1865, the United States' first corporate surety bonding company, the Fidelity Insurance Company, was formed.

Concerns About Contractor Failure

In 1894, Congress passed The Heard Act in response to concerns about the large number of contractors working on public projects who became insolvent and in response to complaints from unpaid subcontractors. The Heard Act was supplanted by the Miller Act in 1935. Since then, the federal government has required that contractors obtain surety bonds for public works, and virtually all the states have followed with their own statutes, called "Little Miller Acts."

Today, surety bonds protect almost every public construction project across the country. In 2010, approximately $300 Billion in public works projects were under construction throughout the United States with surety bonds providing valuable protection against contractor failure.

Why Bonds for Third Party Vendor Contracts?

An economic downturn, labor difficulties, material shortages, the death of a key employee, equipment problems, bad weather, even fraudulent activity, can bring a contract to a standstill, causing the vendor to default and bills to go unpaid.

No public owner can gamble with taxpayers money. For example, a state department of transportation wants to be sure that the vendor hired to take tolls on a bridge will be competent and financially fit. This state

The Bond That Worked

A Service contractor business was established in 2007. Two years later they had numerous third party vendor contracts for armed/unarmed security services and janitorial contracts, all of which were bonded.

Within a year, the owner of the company was arrested and charged with conducting an elaborate workers' compensation scheme that defrauded the state of more than $9.5mm.

The company was effectively shut down overnight. Once the arrest was public knowledge, the surety agent immediately contacted the surety company that bonded the contracts. Between the agent and the surety company, replacement contractors were brought in to take over the contracts.

Each outstanding contract was transferred to a new vendor, new bonds provided to the owners, and the old bonds were released within one week. The bond promised performance and the owner received it.

agency has an added concern: How can he be certain the low bidder is dependable, capable and will not cause a drain on state taxpayers' money?

Surety bonds are the proven vehicle to transfer the performance risk of the vendor from the public body to a federally approved surety company.

Surety Bonds Protect Public Funds

This essential assurance to the public is provided by bid, performance, and payment bonds.

A Bid Bond provides financial assurance that the bid has been submitted in good faith and that the vendor intends to enter into the contract at the price bid and provide the required performance and/or payment bonds.

A Performance Bond protects taxpayers against financial loss should the vendor default or fail to complete the contract according to the terms and conditions of such a contract.

Maintenance/Warranty Bonds can be used after completion of a project to maintain certain services or a guarantee that any work defects found during the warranty period agreed to in the contract will be corrected.

Bid, performance, maintenance/warranty bonds are types of commercial surety bonds. A surety bond is a risk transfer mechanism: the risk of vendor default is shifted from the project owner to the surety company. If the vendor fails to perform according to the contract, it's the surety company that remedies the default—not the government, not the taxpayer. When a vendor provides a surety bond, the public can be assured that the vendor company has met the rigorous prequalification standards of an independent third party, the surety bond company. It is important to note that bid, performance, payment, and advance payment bonds are not intended to protect the vendor companies that post them. Instead, these bonds are intended to protect the owner of the contract against failure to perform as stated in the underlying contract.

Protection Through Prequalification

Surety underwriting focuses on prequalifying a company. This prequalification process is critically important. The surety bond company is committing its assets to guarantee a vendor's performance and that the company completes the contract. That's why surety bond underwriters analyze applicants closely. They must be certain that only those who can successfully complete a particular contract receive a bond, and withhold bonding from those who cannot. To bond all companies regardless of their abilities makes the prequalification process useless and would, in fact, increase defaults.

Before issuing a bond, the surety underwriter must be fully satisfied that the vendor runs a well-managed profitable enterprise, deals fairly with others, and performs obligations in a timely manner.
It's essential that the vendor has the experience that matches the requirements of a specific contract and has relevant experience in completing similar contracts of the same scope.

Surety Gives Green Light for Traffic Control System

A contract for the Virginia Department of Transportation (VDOT) called for the installation of a sophisticated traffic management system on a bridge. A subcontractor to the prime contractor was hired to design and install the system. Unfortunately, the system was seriously flawed and never performed to the specifications mandated by VDOT.

Since the traffic signaling system was a major component of the contract, claims were made against the prime contractor and the performance bond.

The surety supported the contractor in an exhaustive investigation of the problem. With support from the surety, the contractor attempted to rectify the technical problems, but despite its best efforts, was unable to provide a workable traffic system. The contractor could not afford the cost of remedial work nor the cost of outright replacement. VDOT declared the contractor in default and called on the surety to correct the problems and complete the contract.

The surety promptly solicited proposals from other contractors with expertise in the very technical field of traffic management systems. Even the lowest responsive bid to replace the defective system with a workable one required hundreds of thousands of dollars in excess of the remaining contract balance. The surety honored its obligations and provided a check to VDOT for the excess completion costs and tendered an acceptable contractor to complete the contract to VDOT's satisfaction.

In-depth Analysis of a Vendor's Business Operations

How does the surety underwriter make judgments concerning the vendor's work experience, management characteristics, and financial health? He or she gathers and analyzes information from the vendor and various other sources. Some of the information a vendor company provides the underwriter includes:

- an organizational chart showing key employees and their responsibilities and resumes;
- a business plan outlining growth and profit objectives, how contracts are obtained, contract amount and scope, bidding practices, and geographic areas in which work is performed;
- financial statements over the past three to five years, including accountant's opinion page, balance sheet, income statement, expense schedule, changes in financial status, and a schedule of contracts in progress;
- successful completion of similar contracts;
- evidence of a line of credit at the bank and credit history; and
- a continuity plan.

After this information is analyzed, the surety bond company will make its decision. If the comprehensive prequalification process yields a positive conclusion, the surety underwriter then will consider each specific bond request by the vendor company.

Working Together

Surety bonds are obtained through insurance agents and brokers. These professionals guide their clients through the prequalification process and help develop a business relationship with the surety bond company. Agents work closely to assist the contractor in preparing the necessary information and addressing any questions the surety bond company underwriter may have.

What is the cost of this protection? The price or premium for a bond normally ranges from one to three percent of the contract price.

The premium is a fee for underwriting services and stands for:

- a qualified company who is financially sound and capable;
- contract completion;
- the surety's expertise and assistance;
- financial protection for subcontractors, suppliers, and laborers; and
- guarantee of performance for funds paid by owner in advance

It's clear that the in-depth process needed to prequalify a company isn't a simple matter of using standardized formulas, filling in the blanks, and then simply stamping "approved" or "rejected" on the contractor's bond application.

The surety bonding process involves considerable time and effort by all parties involved which makes the final judgment based on the surety underwriter's analysis of the vendor's managerial and financial capabilities.

Why Is There Greater Protection with a Surety Bond vs. a Letter of Credit?

As a surety company will step in to complete a project in the event of default in a contract, it insures that the project will be completed. A letter of credit may provide recovery for financial loss due to an incomplete contract; the owner is still left to find a new contractor to complete the project. The following highlights the differences between Surety Bonds and ILOCs.

Letters of Credit vs. Surety Bonds

	ILOC	Bond
Financial Prequalification	Yes	Yes
Capabilities Prequalification	No	Yes
Review of contract documents and guarantee forms	No	Yes
Guarantee timely completion of project per plans and specs	No	Yes
Prevents liens on project	No	Yes
Warranty Period Covered	No	Yes
Cancellable	Yes	No
100% Coverage	No	Yes
Most acceptable to subs	No	Yes
Impact on Contractors Bank Line	Yes	No

Government Oversight

There are many surety bond companies that sell bonds in the United States. Some are insurance companies specializing primarily in writing surety bonds; others are large property/casualty insurance companies that have surety bond departments and provide other types of insurance coverages as well.

Project owners rely on surety bond protection in part because surety bond companies are regulated by state insurance departments. In general, surety bonds on state public works must be issued by a surety bond company licensed by the insurance department in that state. State insurance departments conduct periodic examinations of surety companies and enforce all insurance laws that pertain to surety bond companies.

In addition, the U.S. Treasury Department maintains a list of surety bond companies that it has qualified to write surety bonds required for federal contracts. To be included on this list, a surety bond company usually must file financial and other information with the Treasury Department and pass the Department's financial analysis. Surety bond companies that don't meet these standards can be removed from the list. The Treasury list may be downloaded from the Internet at **www.fms.treas.gov/c570/ index.html**.

Availability of Surety Bonds

Surety bonds are available to companies of all sizes. It's true that not every company has the credit history, experience, and financial capacity to obtain bonds or may not qualify for as much bonding as it might wish. Nevertheless, it's the intent of the surety bond industry to judge all applicants for bonding on their merit regardless of size.

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