Bonds
Bid-Performance-Payment

SCAGPO 2009

Topics

- What’s a bond?
- Who’s Who?
- Performance Bonds - Pros & Cons

What is a bond? (dictionary)

- “bond, n. 1. An obligation; a promise.”
    - Black's Law Dictionary (8th ed. 2004)

What is a bond? (S.C. Sup. Ct.)

A surety [bond] is a tripartite agreement among the surety company, the principal who is primarily responsible for performing the contract, and the obligee for whose benefit the agreement is made. Suretyship is a contractual relation resulting from an agreement whereby one person, the surety, engages to be answerable for the debt, default, or miscarriage of another, the principal. South Carolina law treats a surety agreement as a credit arrangement where the surety lends credit to the principal who otherwise has insufficient credit to obtain the contract with the obligee."

Masterclean, Inc. v. Star Ins. Co., 347 S.C. 405, 556 S.E.2d 371 (2001) (citations omitted).

Break it down!

Who’s Who? – The Surety

- Surety = “bonding company”
- “surety 1. A person who is primarily liable for the payment of another's debt or the performance of another's obligation.”
    - Black's Law Dictionary (8th ed. 2004)
- (Not a guarantor, but similar idea.)

Who's Who? – The Principal

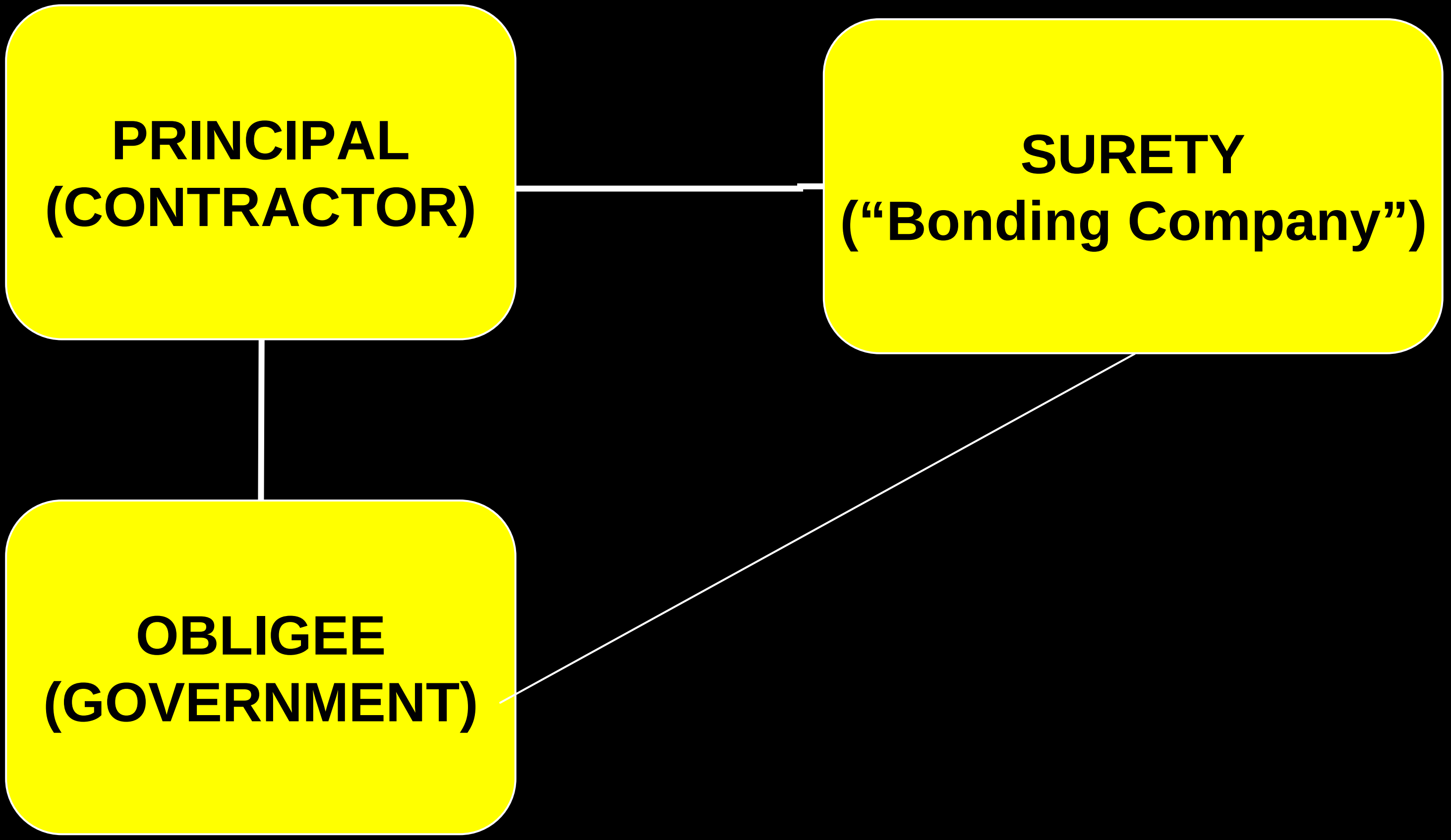
- Principal = the “bonded” Contractor

Who’s Who? – The Obligee

- Obligee = Owner / Government
- pronounced “ob-li-jee”
- **“ob·li·gee** *n. Law.* One to whom another is bound by contract or legal agreement.”
    - The American Heritage Dictionary (3d ed. 1994)

The Relationships

Surety Relationships



Relationships

- Surety - Principal
  - Surety “loans” Principal the Surety’s credit
  - Principal pays Surety for this service
  - Indemnity Agreement - Principal (or its owners) indemnifies Surety for everything

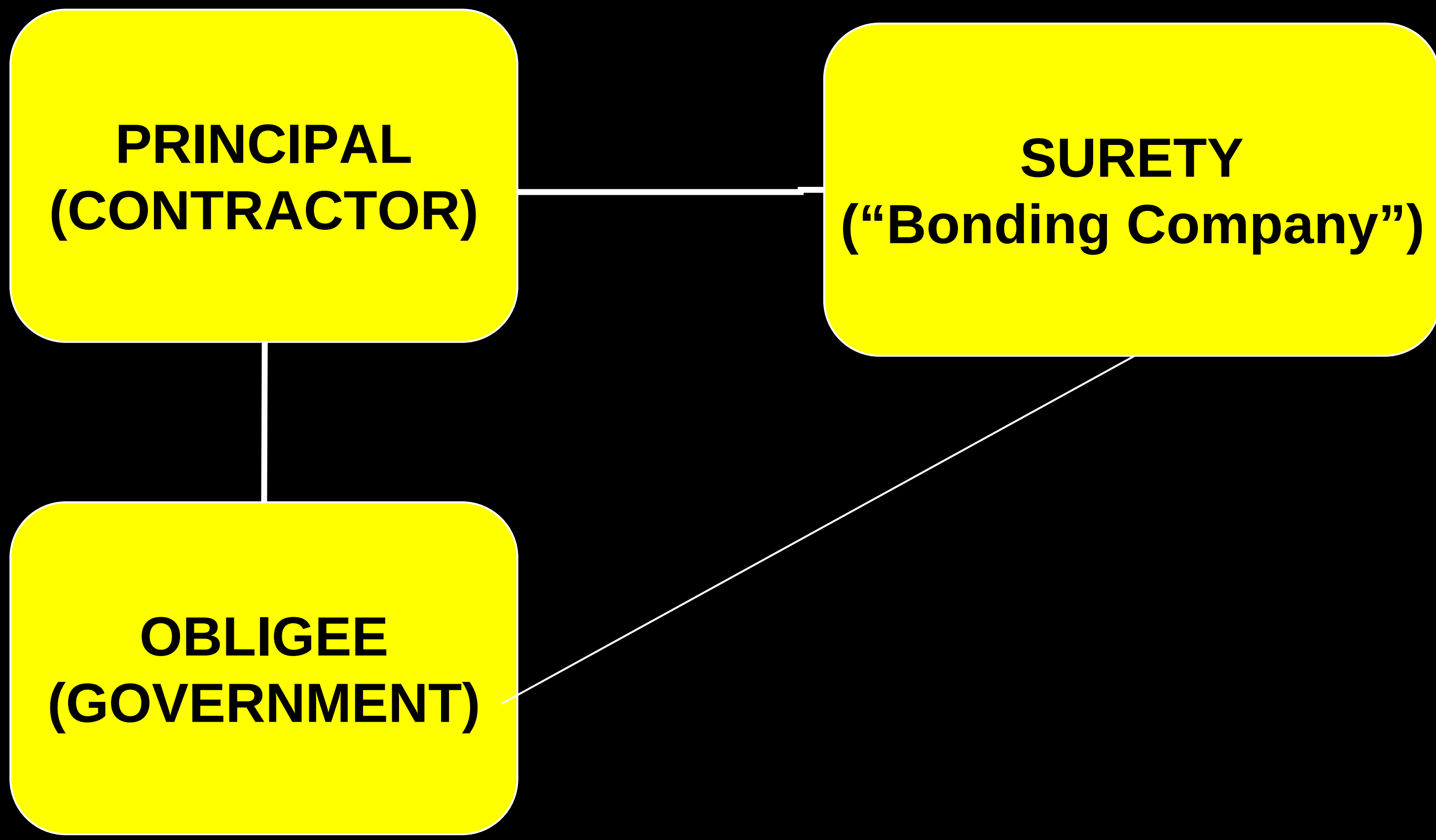
Relationships

- Principal – Obligee
  - Principal contracts to do something for Obligee
    - Bid Bond: intends to contract
  - Contract obligates
    - Principal to provide certain bonds
    - Obligee to pay Principal

Relationships

- Obligee – Surety
  - Surety obligated to Obligee
  - Obligation depends on
    - Terms of Bond
    - Terms of “bonded” contract

Surety Relationships (Redux)



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Bonds are <u>not</u> Insurance

Bonds are not Insurance

- Suretyship involves an extension of credit by which the surety guarantees the principal's performance of its contractual undertaking. Insurance does not.
- The obligee provides the form. Not in insurance.

Bonds are not Insurance

- Surety does not issue a bond with the intent to ever have to pay anything on that bond. They are indemnified against any loss by the Principal (the “bonded” contractor).

Bonds are not Insurance

- An insurance company issues policies of insurance, expects to have to pay a certain number of claims, and prognosticates (by careful underwriting) that it can pay out less than it makes from the premiums paid.

Types of Bonds

- Bid Bond
- Payment Bond
- Performance Bond
- Bail Bond
- Fidelity Bond

Each Type is a Promise

- “bond, n. 1. An obligation; a promise.”
  - Black's Law Dictionary (8th ed. 2004)
- Each type is a type of promise, i.e., regarding bids, payment, performance, etc.

Bid Bonds

Bid Bonds

- ”A bid bond is a very limited kind of performance bond. It is designed to assure only that a bidder, if successful, will, in fact, enter into the contract he has bid upon, and to provide a secure fund to compensate the State if he fails to do so.”
  - Kennedy Temporaries v. Comptroller of the Treasury, 57 Md.App. 22, 27, 468 A.2d 1026 (1984).

Bid Bonds

- Penal Sum usually 5% of contract amount

NOW, THEREFORE, if the Obligee shall accept the bid of the Principal and the Principal shall enter into a Contract with the Obligee in accordance with the terms of such bid, and give such bond or bonds as may be specified in the bidding or Contract Documents with good and sufficient surety for the faithful performance of such Contract and for the prompt payment of labor and material furnished in the prosecution thereof, or in the event of the failure of the Principal to enter such Contract and give such bond or bonds, if the Principal shall pay to the Obligee the difference not to exceed the penalty hereof between the amount specified in said bid and such larger amount for which the Obligee may in good faith contract with another party to perform the Work covered by said bid, then this obligation shall be null and void, otherwise to remain in full force and effect.

Payment Bonds

Payment Bonds

- A bond given by a surety to cover any amounts that, because of the general contractor's default, are not paid to a subcontractor or materialman.

Payment Bonds

- “[T]he bond serves two purposes: it assures the owner a lien-free project, and it induces suppliers and subcontractors to accept work on the project, perhaps at a lower price, because of the assurance that they will be paid. Since no additional charge is generally made for a payment bond when a performance bond is being purchased, the two are usually issued simultaneously.”
  - Grant S. Nelson, Real Estate Finance Law. 12.2, at 881 (3d ed. 1994).

Performance Bond

What You’re Really Interested In

(Unless you’re doing construction.)

Performance Bonds

- “A bond given by a surety to ensure the timely performance of a contract.”
    - Black's Law Dictionary (8th ed. 2004).
- Surety’s liability same as principals - determined by contract

Penal Sum

- Generally, the liability of surety is limited to the amount, or the penal sum, stated in bond.
- Liability of surety is lesser of actual cost to perform or penal sum

Performance Bonds - Pros & Cons

- Pro: Before a surety will bond a contractor, the surety will review, often with a fine tooth comb, the contractor's abilities, his reputation, his experience, his credit, his assets and his past performance.
- Pro: The surety will be there to pay.

Performance Bonds - Pros & Cons

- Pro: Bond continues until contract resolved; no annual renewal like insurance.
- Pro: 200% available to cover losses: Obligee’s contract funds + bond amount

Performance Bonds - Pros & Cons

- Con: Increased Contract Prices: Principal passes costs of Bond to Obligee
- Con: Increased Cost of Claims: involves expenses of both Principal & Surety

Performance Bonds - Pros & Cons

- Con: More Defenses: Surety’s Defenses in addition to Principal’s Defenses
- Con: Principal Still Calling Shots: Surety cannot (practically) pay if Principal objects.

Performance Bonds - Pros & Cons

- Con: Liability usually (effectively) limited to Penal Sum (which may not cover all the actual damages the Obligee has incurred)
- Con: Surety liable only for ‘material’ breach; ‘punch list’ not covered
  - Standard, but depends on bond form

Performance Bonds - Pros & Cons

- Con: Surety's liability co-extensive with Principals - if your contract is poorly worded, adding a surety gets you little.
- Con: Obligee's material default excuses surety.

Performance Bonds - Pros & Cons

- Con: Surety can allow Principal to finish, or hire another contractor.
- Con: Cardinal change can discharge surety
- Con: You’ll need a lawyer schooled in bond litigation

Should I get a bond?

- If the law requires it!
- If you have reason to doubt the contractor's ability to pay any obligations resulting from performance or default of the contract AND the contractor's failure to perform is a <u>show</u> <u>stopper</u> for your entity.
- Otherwise – probably NOT.

Practical Issues

- Performance & Payment Bonds are a contractual performance obligation. You’re entitled to them only <u>after</u> award. (Besides, in RFP, won’t know what’s bonded till proposals in.)
- Bid Bonds work different in RFP: scope of work for two contractors may be different

Practical Issues

- Performance Bonds
  - ***<u>Only as good as original contract!</u>***
  - ***<u>Ambiguous contracts create problems!</u>***

Practical Issues

- You have you specified the acceptable bond (exactly) in your solicitation. Otherwise, you’ll get whatever they happen to provide.
- If it’s worth paying for the bond premium, it’s worth paying someone to help you get the right bond!!!!!!!!

Practical Issues

- The bond is only as good as the paper it's written on and the authority of the person that signed it!!
  - CHECK OUT THE BOND CHECKLIST
- Southco Case.

www.procurementlaw.sc.gov

More Resources Here