

# **Bid, Payment, and Performance Bonds**

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**What they are, How they work, and a Checklist of what you need.**

December 2009

*These training materials provide general information that should be useful to any governmental entity seeking to use bid, payment, or performance bonds in any context. However, it is important to note that these training materials were written primarily for those entering and administering construction contracts governed by the South Carolina Consolidated Procurement Code. Most, if not all, other construction contracts are governed by some statutory scheme, each of which may have different rules. Bonds regarding contracts not involving construction may not be governed by any specific statutory scheme. While we have attempted to reference the state's other statutory schemes, these materials are intended as training materials only. They are not meant to serve as either a comprehensive guide or legal advise.*

## A SURETY

A “surety” is a person (or company or organization) who agrees to be responsible for another person’s promise to pay a debt or perform an undertaking. Sureties can be paid or unpaid. In the construction business, almost all are paid sureties. Although there are many similarities between sureties and insurance companies and they can be one and the same (though not often—they use separate companies), they have different rules and purposes. An insurance company issues policies of insurance and 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. In contrast and most importantly, a surety does not issue a bond with the intent to ever have to pay anything on that bond.<sup>1</sup>

What a surety is doing is lending someone its credit. It is guaranteeing, with its very good credit and financial resources, that someone else will do as they have promised to do. In the realm of construction, bonds are generally used to guarantee that the person or entity they bond (called the “principal”) will do what they promised they would do. For a contractor, it may be a bid bond (a promise by a contractor that he will sign a contract if it is awarded to him—this bond amount is generally 5% or more of the amount bid); a performance bond (that the contractor will do what he has promised to do in the contract he signed—this bond amount is generally for 100% of the contract amount); and/or a payment bond (that the contractor will ensure that certain subcontractors and material suppliers will be paid for the work they do and the goods they provide—this bond amount is generally 100% of the contract amount).

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. Of high importance is whether the contractor has ever had claims made against any bond issued on his behalf and if so, what happened to those claims. Generally speaking, a surety (bonding company) starts out issuing small bonds and, based upon a contractor’s history, experience and assets, will graduate to larger amounts. It is not uncommon for individuals (and their spouses) who own large construction companies to have to pledge all their business and personal assets to bonding companies to ensure that the bonding company can recover its money in the event it ever has to make a payment on a bond it has issued on their behalf. This is done by an indemnity agreement.<sup>2</sup>

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<sup>1</sup> This does not mean that a surety expects that it will never have to pay anything. What it does mean is that a surety will not issue its bond if it has any reasonable basis to believe that it might have to pay on the bond. An insurance company knows and expects to make some payments on some of the policies it issues and it has calculated the odds with respect to how many claims it will receive on a given type of policy compared to the amount of premiums it has received from those it insures. However, while the surety knows that it may be called upon to pay in any given instance, it has protected itself with collateral security for any such payment and thus intends to recoup its payment from its principal and to retain 100% of the premium paid as its fee (ideally).

<sup>2</sup> These indemnity agreements commonly call for the surety (bonding company) to be able to recover 100% of its costs which arise out of its having issued the bond on behalf of its principal (the contractor). For instance, if a claim is made against the bond, it does not matter whether the claim is legitimate or not,

The indemnity agreement<sup>3</sup> that the surety has with its principal (in this case, the contractor), generally says that “whatever I (the surety) have to spend or pay because of the issuance of this bond, you will have to pay me back.” Thus, when a claim is presented to a surety, it has to spend time and money dealing with the claim. And, that same issue or claim will have to be presented to the contractor to determine its agreement as to whether that claim should be paid.<sup>4</sup> When a claim is made against the bond, the cost of dealing with that claim has just increased because not only does the contractor have to deal with the claim (as he would have had to anyway), but now the surety has to deal with it and the surety will be looking to the contractor for reimbursement for the time and money it is having to spend on dealing with that same claim. It is an expensive way to do business and is to be avoided.<sup>5</sup>

Thus, a surety is a person or an entity which says that they will guarantee, with their financial resources, that the person or entity which makes the State a promise (by signing a contract) will do what they have promised to do. In other words, a surety simply uses its financial resources to guarantee a contractor’s promise. Therefore, and this is important, to be able to make the surety fulfill the contractor’s promise with its money, it is critical to be able to establish the exact terms or conditions of the promise made by the contractor. A surety will not undertake to fulfill a promise that is vague or ambiguous. A surety cannot be made to do or perform anything that the contractor cannot be made to do and the surety has all of the contractor’s defenses to any claim made upon the bond by the State or third parties. If a subcontractor claims it is entitled to payment for goods supplied or services rendered on behalf of a contractor and makes a claim against a payment bond because the contractor will not pay him, the surety can raise all the reasons (every defense)<sup>6</sup> for non-payment that the contractor is or was entitled to raise for its refusal to pay the claim in addition to its own defenses.<sup>7</sup>

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if the surety has to spend money investigating the matter, if it has to hire an attorney to defend the matter, or if it has to pay a claim, it will expect to recover its costs and expenses and the amount paid on the claim from its principal, the contractor. It expects that the premium it receives for the issuance of its bond, after deducting its administrative and sales costs, to be 100% profit. This is in contrast to the insurance carrier that expects to have to pay out a large portion of the premium dollars received for the issuance of an insurance policy.

<sup>3</sup> In the surety bond business, an “indemnity agreement” is a written contract whereby a person or entity (the bonded principal), or those with a financial interest in the bonded principal, such as an owner, agrees to compensate the surety for any damage, penalties, fees, expenses or costs resulting from the issuance of the bond by the surety.

<sup>4</sup> Realistically a surety cannot normally pay a claim if its principal (in this case, the contractor) objects. If the surety pays a claim despite the objection of its principal and it is later determined that the claim should not have been paid, it is less likely that the surety will prevail on a claim against its principal to be repaid that sum for obvious reasons.

<sup>5</sup> When a surety is sued on a bond, it is common practice for the surety to permit a contractor who remains in good standing to defend the claim with his attorney because it is the contractor who is eventually going to have to pay both the claim and all attorney’s fees (his and the bonding company’s) anyway. The idea being to avoid paying for two lawyers or law firms when only one is needed to defend the claim and it is the contractor’s money (in the end) which is being spent on the defense.

<sup>6</sup>These defenses are in addition to any defenses that the surety may have against having to make a payment on the bond (for example, the surety may argue that the claim is simply not covered by the

This means that any claim against a surety is only as good as the original promise (between the contractor, the State and its subcontractors and material suppliers) and on top of that, the actual promise made by the surety. Did the surety guarantee everything or just a part? Did the surety bond the contractor for only certain of the contractor's promises? Exactly what are the promises upon which the State or other subcontractors can rely that have been guaranteed by the bonding company? This is what makes the terms of the bond form so critical.

## THE TYPES OF BONDS

Generally speaking, South Carolina governmental entities only deal with three types of bonds issued by sureties with respect to procurement.<sup>8</sup> These are bid, payment and performance bonds—although there are numerous other types of bonds which are required in various circumstances, including fidelity bonds required of many public appointees and employees. Bonds are used in a variety of circumstances from those guaranteeing an individual's appearance in court (bail bond) to those requiring honest service by an employee (fidelity bond). Bonds are generally set for a particular amount of money known as a penal sum. The penal sum or obligation is the maximum amount for which the surety has agreed to be liable and regardless of the actual loss or theft (in the case of an honesty or fidelity bond) or the cost of construction or unpaid subcontractors or laborers. A surety cannot be made to pay more than the penal sum of the bond.<sup>9</sup>

### Bid Bonds

All three common types of construction bonds, bid, payment, and performance, are named for their function. The bid bond is required to ensure that if an award is made to a vendor or contractor, the vendor or contractor will enter into a binding obligation of performance with the State. This means that the bidder will subject itself to liability for a failure to perform the contract sought by the State. For instance, if a bidder offers to supply a product which has a price increase between the time of the bid and the award,

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terms of the bond). The defenses of a surety just get "added on" to whatever defenses the contractor already.

<sup>7</sup> In other words, a lawsuit against a surety is even more difficult than a lawsuit against a contractor because the surety often has more defenses to overcome. Fortunately, as long as the surety is financially responsible, any resulting judgments will be satisfied which is not always the case with a contractor.

<sup>8</sup> Federal procurement rules allow vendors or contractors to post a bond in the form of certain property. The Consolidated Procurement Code does not permit anything but a bond from a licensed surety or a cashiers check in the full amount of the bond. S.C. Code Regs. Ann. § 19-445.2145(C). Compare S.C. Code Ann. § 29-6-250 (2007) ("The bond must be secured by cash or must be issued by a surety company licensed in the State...."). Thus, although attempts are occasionally made to provide personal bonds, they are not acceptable and such bonds are nonresponsive.

<sup>9</sup> Thus, for example, if a surety issues a performance bond for 100% of the contract price and the contractor quits and it will cost more than the penal amount of the bond to complete the project, the surety is liable only up to the amount of the penal sum—not to actually complete the project regardless of cost (except that if the surety undertakes to itself complete the project, it may be required to do so regardless of the actual costs). While there are exceptions to this rule for instances of failure to timely pay claims, absent exceptional or unusual circumstances, a surety's exposure ceases at the penal sum amount.

the bidder cannot decide it no longer wishes to supply the product at the price bid but must enter into the contract if awarded. Since the potential for damages is somewhat limited, a bid bond for 100% of the expected value of the contract is not normally required.<sup>10</sup> Rather, a lesser amount is required—hopefully an amount that will permit the State to “cover” its potential loss of the bid by going to the next lowest bidder to fulfill the contract. In the event the State seeks to enforce a bid bond, it is not uncommon for the defaulting vendor or contractor to allege that it made a mistake in its bid which it contends should be excused or that the State’s contractual requirements are sufficiently ambiguous that the contract (solicitation) cannot be enforced as written due to its inherent ambiguities which were not evident upon reasonable review.<sup>11</sup>

### **Performance Bonds**

A performance bond is often<sup>12</sup> required for 100% of the construction contract amount. The performance bond is to ensure that the vendor or contractor performs as it promised to do in fulfilling the obligations of the contract. As a result, to the extent that a contract is not specific and does not clearly delineate exactly what is required to be constructed, produced or delivered, the State’s ability to insist upon full performance is compromised.<sup>13</sup> Performance bonds usually include virtually all aspects of the agreement of the parties, including quality, quantity and timeliness. A surety may be subject to the payment of damages (liquidated or otherwise) for a contractor’s failure to properly complete a project in accordance with its agreement to do so—likewise, if the agreement is less than clear and unambiguous, it will be that much more difficult to enforce. The bottom line of the performance bond is that it is the surety’s guarantee that the contractor or vendor will perform to the full extent of its contractual promises and if it does not, the surety will either complete the contract or fulfill the obligation or pay for the State’s damages for the failure of its principal to do so.

### **Payment Bonds**

The purpose of a payment bond is for the benefit of unpaid subcontractors, laborers, and material suppliers of the contractor or vendor. The bond is to make sure that those who provide labor and materials to the project, including those who provide services such as security and leased equipment are compensated as agreed by the contractor.

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<sup>10</sup> For contracts governed by the Consolidated Procurement Code but not related to construction, the law does not provide specific rules. For construction contracts governed by the Consolidated Procurement Code, the requirements appear in Regulation 19-445.2145(C). For others, reference should be made to Section 29-6-250 and to the Little Miller Act applicable to your circumstances. See footnote 15 below and the accompanying text.

<sup>11</sup> This problem is often obviated by a careful review of the contract documents and the bond prior to a problem arising. See, e.g., *Mid-States Gen. and Mech. Contracting Corp. v. Town of Goodland*, 811 N.E.2d 425 (Ind. App. 2004)

<sup>12</sup> Section 11-35-3030 and Regulation 19-445.2145(C) address the requirements for construction contracts governed by the Consolidated Procurement Code.

<sup>13</sup> A contract that does not include a complete description and is not precise about detail is difficult to enforce with a party, such as a surety, that cannot be told that they knew or should have known something when all they had to rely upon were the contract documents that existed between the principal (the contractor or vendor) and the State. A surety is not bound morally or as a matter of law by what the parties “understood” but rather by what they reasonably agreed to do as evidenced by their written contract.

In projects involving the government, it is presumed that the government will pay that which it agreed for proper performance. However, because there is no assurance that the contractor, once paid, will actually pay its subcontractors or material suppliers, the bond exists to ensure that they do not remain unpaid without the ability to collect from a contractor having financial problems and from whom the subcontractor cannot collect. Because, under most circumstances, the State's property is not subject to a mechanics' or other lien by a contractor or vendor, statutory law requires that the contractor post such a bond to effectively take the place of the collateral being constructed. The requirement for payment bonds when dealing with the federal government is found in the "Miller Act"<sup>14</sup> or, in the case of states, the "Little Miller Acts"<sup>15</sup> (the latter is the name generally given to the state laws requiring such bonds which vary from state-to-state) because government property is not subject to a builder's (mechanic's) lien.<sup>16</sup>

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<sup>14</sup> 40 U.S.C.A. §§ 3131-3133.

<sup>15</sup> South Carolina has several "Little Miller Acts," each applying to a different set of circumstances. *E.g.*, S.C. Code Ann. § 29-5-440 (2007) (Suit on payment bond), § 11-1-120 (Suits on payment bonds, remote claimants) (Supp. 2008), §11-35-3030(c) (Suits on Payment Bonds – Right to Institute) (Supp. 2008), § 57-5-1660 (Contractors' bonds; amounts and actions thereon) (2006). In addition, South Carolina has its Subcontractors' and Suppliers' Payment Protection Act (SPPA), S.C. Code Ann. § 29-6-210 et. seq. (2007), which in some circumstances must be read in conjunction with the applicable Little Miller Act. For a discussion of the interplay between these laws, read the opinion issued on March 24, 2008 by the South Carolina Supreme Court in the case of *Sloan Const. Co., Inc. v. Southco Grassing, Inc.*, 377 S.C. 108, 659 S.E.2d 158 (2008). This decision greatly altered the landscape of liability of the State for the unpaid claims of subcontractors and material suppliers by greatly expanding the potential liability of the State in the event that a payment bond fails to satisfy the claims of subcontractors and material suppliers.

<sup>16</sup> See, *Atlantic Coast Lumber Corp. v. Morrison*, 149 S.E. 243 (S.C. 1929) and 1916 Op. Atty Gen. 163.

## BOND CHECKLIST EXPLANATION

*Even when you are familiar with bond forms and their appearance and content, a checklist should be used to avoid overlooking a deficiency which is not obvious and might make the surety's promise questionable.*

**1. Do you have the Required Bond Form?** Make sure that the form of bond that has been provided is exactly what was required and that no changes to the form have been made.<sup>17</sup> Bond forms and thus their agreements can appear to be very similar. In fact, most companies have their own form using (what appears to be) very similar language. Most of them appear to do essentially the same thing. However, **bond forms can be very different and are not readily interchangeable.** If a solicitation calls for a bond to be submitted on a State form (like the SE-355, SE-335 or SE-357) and it is provided on the bonding company's form, you may be relatively sure that the company's bond form does not provide the same protection as is required by the State's form and that it offers less protection—sometimes a great deal less protection.<sup>18</sup> Thus, the first thing to do is to make sure that the correct form and type of bond has been submitted<sup>19</sup> and that the bond contains the required terms and any exceptions to its coverage are specifically authorized.<sup>20</sup> If it is not the exact form you required,<sup>21</sup> the offeror is nonresponsive.

**2. Do you have Original Documents?** The State's bond forms are never originals but copies and often the bonds supplied by commercial sureties are also copies. The same applies to powers of attorney. What is important is that all the signatures on the bond form are original signatures and that the stamps on both the bond form and the power of attorney are raised or otherwise appear authentic (after careful examination). If you cannot read the seal, do not accept the document.

**3. Are the Signatures Original and Authentic?** If the signatures are not original and were made by a machine, a stamp, or are copied/copies, that is not good enough.

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<sup>17</sup> It is not unknown for those who wish to deceive to copy a form exactly and, in the same size and typescript, change the terms of a document. The reviewer often fails to notice such changes because of the nature of the document and the fact that, without careful scrutiny, it appears to be identical.

<sup>18</sup> If the bond provided is on the form of the surety when the solicitation requires that the State's form be used, the bid or offer is, to a fairly high degree of certainty, not responsive. Submission of the bond on a form other than the one required by the solicitation does not permit the deficiency to be cured. The Procurement Code allows a brief opportunity to make a correction only when either the amount of the bond or the surety's rating is incorrect. S.C. Code Ann. §11-35-3030(c) (Supp. 2008).

<sup>19</sup> While the federal government permits many different types of sureties and security to be posted to meet their requirements, the Procurement Code does not. The Procurement Code only permits certain licensed sureties (as described) and "certified cashier's checks" (a document you are not likely to ever see and whose presentation would require immediate confirmation from the issuing bank) to satisfy its bonding requirements. S.C. Code Regs. Ann. 19-445.2145(C) (Supp. 2008).

<sup>20</sup> You must make sure that any riders or exceptions to the bond are authorized by the contract.

<sup>21</sup> If you required a certain form, you can be fairly sure that a form used by a bonding company has many material differences and provides less protection than the form used by the State.

All signatures on the bond form must be original signatures.<sup>22</sup> There is no exception to the rule nor is there any excuse for not providing original signatures on a bond form.<sup>23</sup> The bond forms themselves are important enough documents that original signatures are always required—with no excuses.<sup>24</sup>

**4. Are the Signatures Authorized by the Surety?** Once you know that you have the correct form, make sure that the bond is actually signed by the persons whose signatures purport to be on the papers. This means that the bond form has to be signed by someone from the surety who has the authority to act for the surety company's board of directors—this is generally an officer of the surety like the president, executive vice-president, treasurer or secretary.<sup>25</sup> It is important to be able to read the signatures of those who signed the bond (an indecipherable scribble is not sufficient) and for you to be able to confirm that (a) the person who signed the bond on behalf of the surety is authorized to sign that type of bond (performance, payment, bid), (b) that the person who signed is also authorized to sign bonds for the amount of money set forth in the bond (what is his/her authority?); and, (c) that the person who signed did so within an authorized time period. The next step is to make sure that everyone else who signed the bond was authorized to do so. With respect to the surety, this is normally accomplished by the attachment of a "Power of Attorney".<sup>26</sup> A Power of Attorney is generally signed by a high-ranking officer of the bonding company whereby he or she grants to certain specific individuals (not companies or agencies) the right to bind the surety by issuing bonds in its name for which it will be liable. The Power of Attorney must be examined to make sure that the person who signed the bond is specifically designated in the Power of Attorney to sign on behalf of the surety and that the same person has the monetary authority to bind the company for the amount of the bond (and

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<sup>22</sup> It is common for those signing original documents to do so in an ink other than black so that it is easier to discern that a signature is original. On black and white copies, all signatures look black and to sign an original document in black makes it more difficult to tell a copy from an original. Thus, unless the signature is in a color other than black, you may not be able to tell if it is an original and unless you can do so, you cannot accept the document as an original (let them sign in blue, blue-black, green, red or some other distinctive color—they should already know to do so).

<sup>23</sup> Is failure to provide an original signature for a bid bond non-responsive? Possibly it is. It would depend upon whether all signatures were copies and the documents were generally questionable or whether the copied signature was on an otherwise authentic-appearing bond form with other indicia of authenticity. There is no good excuse for providing a bond form with a copied signature however, some judgment is always required.

<sup>24</sup> A Power of Attorney probably will not have original signatures but instead will have stamps or other indicia of originality that are difficult to copy or duplicate thus precluding forgery.

<sup>25</sup> What this means is that you have to make sure that the person who purports to have the authority to bind the company (the attorney-in-fact) has been authorized by the bylaws or board of directors. Going to the surety's bylaws or board minutes is not necessary since you can rely upon senior officers of the company having the necessary authority but, you need to make sure that whoever signs for the surety to bind the surety has been given the authority to do so by someone else who has the requisite authority to permit the signature you have been given to bind the company. Just make sure everyone is authorized. Look at the person signing the bond and confirm his or her authority all the way back to the senior officers of the surety.

<sup>26</sup> A power of attorney is simply "[a]n instrument granting someone authority to act as agent or attorney-in-fact for the grantor." Black's Law Dictionary (8th ed. 2004). An attorney-in-fact is simply "one who is designated to transact business for another," not necessarily a lawyer. *Id.*



the type of bond) issued.<sup>27</sup> All of this information is determined by reading the Power of Attorney<sup>28</sup>—in other words, exactly what authority did the surety give this person (who signed the bond) and when and how are they authorized to exercise it?

**5. Are all Signatures Witnessed?** If spaces on the bond are provided for witnesses to sign, have they been signed in ink and can you read the name of the witness? Those signatures must also be legible and original.

**6. Are the Bond Documents Complete?** Ensure that everything is properly filled-in on the form so that you know who signed everything and the companies are accurately and correctly identified. Have you been to the State Engineer's web page and checked everything required by reviewing the document entitled "**Web Site Verification for Surety Companies**"?<sup>29</sup> There should be no blank spaces and no missing information. There should be nothing left to be added. Make sure the dates match when the documents should have been signed at the same time. There can be no corrections, changes or erasures.

**7. Are the Bonds in the Correct Amounts?** Look and triple-check that the bonds are in the correct amounts and that the figures match. If the bond amount is written in numerals then make sure it matches the amount written in words. Make sure the bond amount is the correct amount—not more, not less. A surety does not write bonds for more than is required and you should not accept a bond that is for an amount different than what is required.

**8. Do All the Documents Look and Feel Authentic?** You are not expected to be an expert in detecting forgeries but unless you have personally witnessed the parties sign the documents, be suspicious. Look at the documents and decide whether they feel right. If the bond is an original is it on a higher grade of paper than normal? It should be.<sup>30</sup> They generally have seals upon them and must be signed in ink. Examine

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<sup>27</sup> Just as surety companies are limited in the amount of money for which they can issue bonds—some companies are limited to hundreds of thousands of dollars while others (very few) can issue bonds in the billions of dollars—it is not unusual for powers of attorney to be limited to certain amounts and these amounts are often specifically expressed in the individual's power of attorney. In other words, the surety says that someone can bind them but only for a certain type of bond, perhaps during a certain time period, and only up to a certain amount. Thus, as boring as it may be to read, the entire Power of Attorney has to be read to determine not only the authority of the signor of the bond but his or her limitations. Also, the name on the Power of Attorney of the authorized person must be identical, not just similar, to the name of the person signing the bond. ("John Q. Doe, II" is not the same as "John Q. Doe")

<sup>28</sup> A Power of Attorney is generally signed by a high-ranking officer of the bonding company whereby he or she grants to certain specific individuals (not companies or agencies) the right to bind the surety by issuing bonds in its name for which it will be liable. The Power of Attorney must be examined to make sure that the person who signed the bond is specifically designated in the Power of Attorney to sign on behalf of the surety and that the same person has the monetary authority to bind the company for the amount of the bond (and the type of bond) issued.

<sup>29</sup> The document is found at:

[http://www.mmo.sc.gov/webfiles/OSE\\_main/Forms%20and%20Pubs/surety1.pdf](http://www.mmo.sc.gov/webfiles/OSE_main/Forms%20and%20Pubs/surety1.pdf)

<sup>30</sup> In other words, if you were a surety who was issuing paper telling people to trust you and that you would stand good for the promises of another, would you issue your promise on quality paper which would inspire confidence in your word or representation? Similarly, is the seal raised and clearly legible?

the seal and the signatures on each and every document related to the bond. Is the seal raised? Is it on a type of gold or other foil that has no special markings or is it of a type that has been manufactured so as to avoid forgeries (that a local printer would have difficulty in duplicating)? Is the seal impression clear, distinct and more impressive than that of a notary? Are there smudges, other evidence of sloppy drafting or copier marks? There shouldn't be. Take a hard look at the documents with an eye toward detecting whether anything may be wrong with them and if there is, follow up and satisfy your suspicions, one way or the other. There is no such thing as being overly careful when accepting the promise of a surety to be responsible for the performance or payment of the debts of another.<sup>31</sup>

**9. Do the Bonds fully cover their Intended Purpose?** The description of what the bond covers must be distinct and clear—there can be no ambiguity or question about what the surety is agreeing to do (and by inference, not to do). What does the bond say it is going to cover—be careful of the exact language and do not accept any language that could be misinterpreted? If the surety is asked to pay the full amount of the bond, can it point to any of the language about what it promised to be bound to do and raise a question about the extent and breadth of its promise? Is there any language which should not be there which may raise a question or can be used to modify other language? Don't accept anything about which you are not positive what it means. (Of course, if you have provided the bond form, these concerns were addressed when you specified what bond language would be acceptable.)

The bond must distinctly refer to the contract or solicitation or both and must provide that it is issued for the purpose of guaranteeing some payments or performances to which the contractor (principal) has agreed. Again, make sure the dates of the start of the contract period agree with the date of the start of the bond (if its performance or payment). It must be clear what the surety is agreeing to do and if you cannot understand the language or a term in the bond, find someone who does.<sup>32</sup>

**10. Have you read the bond documents, Word-for-Word?** If not, do so. These are promises that the law requires to be in writing for a specific purpose.<sup>33</sup> If you cannot

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The seal on the bond and the power of attorney are important elements that you must carefully examine for forgeries and the use of unauthorized seals. People forging bonds have been known to substitute the seal of a notary public for that of a surety company.

<sup>31</sup> If you think that you are being overly cautious or “nit-picky” don't worry. This is one time when you are entitled to insist that every “jot and tittle” be exactly as it should.

<sup>32</sup> What the bond should be doing is saying that the bonding company (the surety) is promising the “obligee” (pronounced ob-li-jee—the government), that the contractor will perform all things required of it and once it has fully performed, then the surety's obligation is void and it is relieved of all liability to the obligee (there can, in some circumstances, be more than one obligee). In other words, when the vendor or contractor has done everything it said it would do, the surety is relieved from its obligation and it is no longer capable of being held liable on the obligation for which the bond was issued.

<sup>33</sup> In most states (including South Carolina) certain promises or agreements are considered to be sufficiently serious and important that the law requires them to be in a certain form. Generally speaking, a promise by one person to be responsible for the debt of another must be in writing (“If he doesn't pay you, I will”). If it is not in writing, there is a statute that says the promise cannot (generally) be enforced. The reason, among others, is it is too easy to lie about something like that and it is too easy to lie (or be

read the bond and understand exactly what the surety is promising to do and how and why and when, read it until you can—otherwise you cannot confirm that you have the right type of bond form.<sup>34</sup>

### ***Further Confirmation Steps***

**11. Have you Written to the Surety to Confirm the Bond's Issuance?** To prevent against the possibility of relying upon a bond or bond form which is not binding or to which a surety has not agreed, it is good practice to confirm the issuance of the bonds (generally payment and performance) directly with the issuing surety. This means that writing or calling the surety (or both) is the best method of confirming that the bonds were authorized to be issued in the amount and for the reasons for which they have been presented. If you call, use the telephone number of the surety that you obtained from a trustworthy source such as the Department of the Treasury website or from the Department of Insurance.<sup>35</sup> Keep a record of the person who confirms the bond's issuance, the amounts and purpose of the bonds. Then, write a letter to the surety confirming the conversation and referencing the issued bonds by number and subject and ask for a written confirmation in response.

**12. Is the Surety Financially Qualified?** The regulations<sup>36</sup> require that a surety supplying a bond meet certain financial standards. The purpose is to ensure the financial solvency of the surety throughout the contract period since the State is relying upon the creditworthiness of the surety for that period of time. A place to double-check the financial worth of a surety is to review the information at the website for the Department of the Treasury<sup>37</sup> which provides the maximum amounts for which the federal government will accept a bond from that surety—this is useful if you have any concerns about the named surety and its financial ability.<sup>38</sup>

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confused) about the exact terms of the promise ("I said if he dies and doesn't pay you, I will"). Thus, the law says that if you want to know what the promise was, exactly, read what the parties agreed to in writing—that way there will be no misunderstanding. A bond falls within that statute (called the "Statute of Frauds").

<sup>34</sup> The one exception to this rule is when you have confirmed that the terms of the bond are identical to the terms of the State bond but, you can be assured that sureties do not provide language that is identical to the language required in the State bonds without being required to do so.

<sup>35</sup> Attached as an Appendix is a sample inquiry letter and a sample form which may be used. You can obtain email addresses, telephone numbers and other information for authenticating bonds from the Bond Obligee Guide, which is available from The Surety and Fidelity Association of American at the following website:

<http://www.surety.org/pdf/BondObligeeGuide2008.pdf>.

It is also a great site to learn more about bonds and sureties.

<sup>36</sup> For construction contracts governed by the Procurement Code, regulation 19-445.2145(C)(1)&(2) sets forth the exact requirements for the rating of a surety issuing various types of bonds for construction and which publication to use and permitted deviations from those requirements.

<sup>37</sup> <http://www.fms.treas.gov/c570/c570.html>

<sup>38</sup> Sureties sometime fail. If they make mistakes and write bonds for people or entities who are not responsible and do not have the requisite collateral, their losses can be catastrophic. Depending upon the size and length of the bonded performance, you will need to decide when and how often to check on the surety and its financial health. This is a matter of discretion. How big is the surety (is it a surety which can write a billion dollar bond) and how big is the risk (a five hundred thousand dollar bond)? How long will the

**13. Is the Named Surety Licensed in South Carolina?** Remember to use the exact name of the surety, not a “sound-alike” or similar name. Check with the South Carolina Department of Insurance either on their web site or by telephone. This same source can also provide address and telephone contact information to ensure the information you have is accurate. It does not matter that the bond was received from or through a currently licensed insurance agent or broker—the surety must also be licensed.

**14. Have You Established a Bond Verification File?** Consider establishing a bond verification file for bond related records. In the file should be your notes about what you did to verify the validity of the bond (and when you took those actions) and copies of the letters you sent and received from the surety confirming the issuance of the bond. Remember that although the bonds are acquired by the contractor, it is the State which is paying the premium for the bond through its payment to the contractor for the project. Make sure that the file documents that the State received all that it was entitled to receive and that the issuance of the bonds was an act authorized by the Surety. It is up to you to verify that the State has received that for which it has paid.

**13. Have You Established Follow-Up Dates?** Depending upon the particular project, establish dates to check with the surety about its knowledge (or lack thereof) of progress on the work. Set dates to find out whether the surety has received any claims against the payment bond or whether it has had to intercede to ensure that subcontractors or material suppliers have been paid. Let the surety know (occasionally) that you are relying upon it to ensure that the contractor pays his bills and performs his work and that you have not forgotten its promises to the State. Keep track of the surety’s financial viability by occasionally checking its ratings and financial reports if there is any concern about its ability to adequately perform in the event it is needed. A ninety day period is a good time frame to establish for all of the tasks listed in this paragraph, including the financial condition and viability of the surety.

**14. What do you do When. . .?** What happens when someone in your office is told by a subcontractor that your contractor hasn’t been paying on-time? Do they tell you? Are payments to the contractor stopped until the matter is resolved? Is it handled on a case-by-case basis? The answer is probably the latter.<sup>39</sup> But, you need to have an established protocol for what is to be done when problems such as this arise.<sup>40</sup> You

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bond have to remain in effect? How financially stable is the contractor or vendor? Has anyone made inquiry about the bonds or have there been any claims made upon the payment bond? You have to decide how often the size and type of contract justifies making sure the surety remains responsible and capable of financially guaranteeing the payment or performance of the entity who has the contract.

<sup>39</sup> Such a circumstance could obviously be the first sign that the general contractor is having financial problems but it could also be notice of problems with that particular subcontractor. The contractor may be intentionally withholding payment to get the subcontractor to perform or correct work. There are many explanations but they need to be understood.

<sup>40</sup> In the event that you learn of the failure of a surety or have any other reason to believe that a surety will have to make payments to your agency or other third parties under a bond issued to you as obligee, stop all payments to the contractor or vendor (the “principal”) until you have consulted with legal counsel. Do not continue to make payments under a contract when you know that the contractor or vendor is in breach of that contract by impairing your security for the completion of the project or the payment of

need to know who makes the decision when to stop payment to the contractor and who is notified (and how). It needs to be clear how problems are handled and to whom they must be reported. If you are assigned the responsibility of coordinating with the surety, you must know when problems arise and their severity. If in doubt, it is never too early to contact your lawyer but it can sometimes be too late.

**15. Have You Followed All the Rules?** If it's a construction project have you checked the State Engineer's Manual to ensure that you have obtained all necessary forms? For instance, have you obtained the written consent of the surety to make the final payment to the contractor? There is a form in the Manual for just about everything.<sup>41</sup>

## Problems

Problems almost always arise and there is no simple answer about what to do. If a question arises about whether the surety should be notified about a problem, whether it's a failure of payment that may be easily explained or a delay in the progress of the work, it is not too early to talk with your attorney. It is never too early to consult your lawyer—especially if you are unsure. However, if there is a general rule, it is “when in doubt, notify”—and keep a record of your notification and that it was received and by whom. While notification may injure the relationship you have with your contractor, particularly if it was an unnecessary notification and the result of some misunderstandings, you will not be prejudiced by having given the notice—especially if it turns out to be justified.

It should not be forgotten that the interests of a surety are aligned with the interests of the contractor. However, under certain circumstances, a surety can assist in persuading a reluctant contractor to perform according to the terms of its contract. This is for the reason that the surety wants the contractor to provide adequate performance so that it will not be called upon to perform its obligations under its bonds. But, in terms of alignment of the various entities, the surety is aligned with the contractor because the contractor's defenses are also its defenses to any payment. Cooperate with the surety but understand that the surety is the contractor's financial guarantor, not yours.

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everyone under the contract documents. It is important that your agency have a mechanism whereby payments can be temporarily placed on hold in the event that a claim is made against a bond or the continued viability of a bond is placed into question. You cannot ignore or discount either event nor can you permit the agency to continue payments to a contractor or vendor when either circumstance exists. Either event may very well be a serious material breach of the contract from which the agency may not be able to recover unless you act immediately.

<sup>41</sup> It is not only a good idea to check the Manual but also to review the forms made available in the Manual and related information when obtaining surety bonds. The following web site should also be of some assistance:

[http://www.mmo.sc.gov/MMO/webfiles/OSE\\_main/Forms%20and%20Pubs/surety1.pdf](http://www.mmo.sc.gov/MMO/webfiles/OSE_main/Forms%20and%20Pubs/surety1.pdf)

Questions often arise about when to suggest<sup>42</sup> to subcontractors or material suppliers that they make a claim upon the bond or how quickly claims should be made or how often or under what circumstances. These are all questions that need to be directed to legal counsel and cannot be answered with general advice or instructions.

### **Basic Information**

The *S.C. Code Ann.* § 11-35-3030 primarily relates to bonds for construction projects but the principles set forth in that section and its accompanying regulations (R. 19-445.2145(C)) set forth requirements and standards which can be used for all bonds, whether for construction or otherwise. A bond used in a construction project is no different (in principle) than a bond used in a goods and services setting. They perform the same function in all areas of procurement. They are a means of ensuring that the State and its taxpayers will receive value for purchases made by the State and that those with whom the State deals with will be treated in a fair and equitable manner.

A vast amount of reliable information is available on the internet. Websites hosted by the following organizations may be particularly helpful:

Surety & Fidelity Association of America

[www.surety.org](http://www.surety.org)

Surety Information Office

[www.sio.org](http://www.sio.org) (Go to the link "Brochures and CDs" for information you can download for free.)

National Association of Surety Bond Producers

[www.nasbp.org](http://www.nasbp.org)

The Supreme Court in South Carolina has recently expanded what was understood to be the liability of a State agency for its failure to ensure that subcontractors and material suppliers were protected by a payment bond. Your attention to the detail of what is provided to the State is of critical importance in preventing the State from being made a victim of the fraudulent and criminal acts of others.

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<sup>42</sup> The use of the word "suggest" might be thought to imply that there is a time when you should "suggest" to someone to make a claim—however, if you take upon yourself the duty of "suggesting" when claims should be made, are you willing to assume the liability of not giving adequate suggestions? Your job is not to suggest or advise but to provide the information that is requested—which does not extend to advice about when to make claims.

## SURETY BOND CHECKLIST

### *Upon Receipt of the Bonds*

#### YES

- Is the bond in correct and unmodified form? (Required form and unaltered)
- Do you have raised or hard-to-counterfeit seals on the bond and Power of Attorney?
- Are all signatures on the bond form original and authentic? (Mandatory)
- Are the signatures on behalf of the Surety authorized by a Power of Attorney?
- Is the Power of Attorney sufficient (sufficient amount and purpose—type of bond)
- Is the Power of Attorney complete? (Read it all)
- Are the names and titles of the witnesses clear and legible?
- Are all spaces filled in and complete? (Should be no blank spaces)
- Is the amount of the bond (penal sum) in the correct amount and do the numerals agree with the written amount?
- Does the bond amount correspond exactly with the contract amount?
- Are the seals either raised or of a type that is hard to copy or forge and are they in the proper place?
- Have you checked the paper for watermarks or copy prevention devices? (Often present)
- Is the name of the principal exactly the same as the name on the contract and consistent throughout?
- Is the project / contract specifically and correctly described?
- Do the project and contract names match those on the actual contract documents?
- Are all addresses complete?
- Is the date of the bond the same date as the contract?
- Are appropriate signatures signed in ink? Are you sure?
- Does the Power of Attorney specifically and exactly name the person who signed the bond form?
- Is the Power of Attorney recent and does it pre-date the signing of the bond?
- Have you made sure that there are no corrections, changes or erasures on any of the documents?
- Is the Surety licensed in South Carolina?
- Have you checked the rating of the surety?
- Have you read all the bond documents word-for-word?
- Are the forms correctly completed without errors?
- Have you confirmed the issuance of the bond with the surety by telephone?
- Have you confirmed that the address of the surety on the bond is their advertised and public address?
- Have you written the surety to confirm the issuance and amount of the bond? (Appendix A / B)
- Have you set up a file for the bond documents and notes and correspondence?

### ***30 Days After Receipt Of The Bond***

**YES**

- Do you have a letter from the Surety confirming issuance of the bond in your file?
- Have you calendared dates to check on the financial health of the surety?
- Does everyone know you must be told of any financial issues regarding the vendor or subs?

EXPLAIN ALL UNCHECKED BOXES OR MODIFICATIONS HERE



## APPENDIX “A”

South Carolina Department of Good Government  
1200 Main Street, Suite 2600  
Columbia, South Carolina 29201  
803.734.0001

January 2, 2010

C. Charles Goodman  
Vice-President  
South River Insurance Company  
1 Franklin Square  
Philadelphia, Pennsylvania 19106-1587

Re: Payment/Performance Bond  
SC State Project # RT44066  
Principal: Justin Time Construction Company, Inc.  
Obligee: South Carolina Department of Good Government  
Bond Number: TRS4046151

Dear Mr. Goodman:

I am in receipt of a payment/performance bond issued by your company, as surety, referenced above, for the construction of a Sports Center here in Columbia, South Carolina. The penal sum of the bond is in the amount of one million four hundred forty dollars (\$1,000,440.00). A copy of the bond is enclosed.

Please confirm for me by return mail that the original of this bond was issued by your company as indicated thereon and that it remains in full force and effect at this time. In addition, it would be appreciated if you would provide the name, address and telephone number of an individual whom I can contact with respect to any issues arising with regard to the bond or the progress of the Project.

I look forward to your confirmation of the issuance of the bond.

Sincerely,

Mary Smith Dellgent  
Construction Coordinator

## APPENDIX B

### **BOND AUTHENTICITY INQUIRY**

TO: NAME AND ADDRESS OF SURETY:

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This bond or bonds described below have been presented to us. Please acknowledge that these bonds have been provided by your company.

A copy of the bond(s) may be submitted in lieu of providing the information marked with an asterisk (\*)

\*BOND NUMBER (IF ANY): \_\_\_\_\_

\*NAME AND ADDRESS OF PRINCIPAL ON THE BOND (IF PRINCIPAL IS A JOINT VENTURE, INCLUDE NAME OF ALL PARTIES):

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\*NAME AND ADDRESS OF OBLIGEE: \_\_\_\_\_

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\*AMOUNT OF PERFORMANCE BOND: \_\_\_\_\_

\*AMOUNT OF PAYMENT BOND: \_\_\_\_\_

\*DATE BOND EXECUTED: \_\_\_\_\_

\*NAME OF PERSON SIGNING BOND FOR SURETY: \_\_\_\_\_

\*BRIEF DESCRIPTION OF THE PROJECT: \_\_\_\_\_

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This is a Training Document and does **not** establish a Required or Mandatory Standard of Care—it is for guidance only and its use is optional

PLEASE SEND CONFIRMATION TO: NAME AND ADDRESS:

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VALIDITY CONFIRMED:

COMPANY NAME: \_\_\_\_\_

SIGNED BY: \_\_\_\_\_

PRINT OR TYPE NAME: \_\_\_\_\_