

Surety Bonds vs. Bank Letters of Credit

Definitions	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • A three-party agreement among the surety, the <i>obligee</i> (the project owner), and the <i>principal</i> (the contractor). • A performance bond protects the owner from non-performance and financial exposures should the contractor default. • A payment bond, aka labor and material bond, protects certain subcontractors, laborers, and material suppliers against nonpayment by the contractor. 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • A bank letter of credit (LOC) is a cash guarantee to the owner, who can call on the LOC on demand. The LOC converts to a payment to the owner and an interest-bearing loan for the contractor. • The performance of the contract has no bearing on the bank's obligation to pay on the letter of credit.
Prequalification	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • A surety company and producer assess the contractor's business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to verify the contractor is capable of performing the contract. The purpose is to avoid default. 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • The banker examines the quality and liquidity of the collateral in case there is a demand on the letter of credit. If the banker is satisfied that the contractor can reimburse the bank if demand is made upon the LOC, there is no further prequalification.
Borrowing Capacity	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • Performance and payment bonds are usually issued on an unsecured basis and are usually provided on the construction company's financial strength, experience, and corporate and personal indemnity. The issuance of bonds does not diminish the contractor's borrowing capacity and may 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • Specific liquid assets are pledged to secure bank LOCs. Bank LOCs diminish the contractor's line of credit and appear on the contractor's financial statement as a contingent liability. The contractor's cash flow in funding initial stages of construction and retention amounts

<p>be viewed as a credit enhancement.</p>	<p>throughout a contract term can be adversely affected.</p>
<p>Duration</p>	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • Surety bonds remain in force for the duration of the contract plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes. 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • An LOC is usually date specific, generally for one year. LOCs may contain “evergreen” clauses for automatic renewal, with related fees.
<p>How To Obtain</p>	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • The contractor obtains the bond through a surety bond producer. 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • The contractor obtains the LOC through a banking or lending institution.
<p>Cost</p>	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • Generally 0.5% to 2% of contract price. Bond is project specific, covers duration of contract. • Included in contractor’s bid price. 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • Cost is generally 1% of the contract amount covered by LOC - e.g. if LOC covers 10% of contract, Cost = 1% x (10% x Contract Amount) x years of contract. • Included in contractor’s bid price.
<p>Coverage</p>	
<p>Surety Bonds</p> <ul style="list-style-type: none"> • Performance bond - 100% of the contract amount for project completion. • Payment bond - 100% of contract amount protects certain subcontractors, laborers, 	<p>Bank Letters of Credit</p> <ul style="list-style-type: none"> • The LOC may be obtained for any percentage of the contract, but 5% to 10% is typical. • No protection/guarantee that

and materials suppliers and protects owner against liens.

- At least 10% coverage for maintenance of defects the first year after completion.

subcontractors, laborers, and materials suppliers will be paid in the event of contractor default. They may file liens on the project.

Claims

Surety Bonds

- If the owner declares the contractor in default, the **surety investigates**.
- If the contractor defaults, the **surety's options** are to:
 - Finance the original contractor or provide support;
 - Takeover responsibility for completion (up to penal sum of bond);
 - Tender a new contractor; or
 - Pay the penal sum of the bond.
- With payment bonds, the **surety pays the rightful claims** of certain subcontractors, laborers, and suppliers up to the penal sum of the bond.

Bank Letters of Credit

- The bank will **pay on an LOC upon demand** of the holder if made prior to the expiration date.
- There is **no completion clause** in an LOC. The task of administering completion of the contract is left to the owner.
- The **owner must determine the validity of claims** by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.