What you may not know about bid bonds can cause severe damage and financial loss to your business. Interesting thought when bids bonds are provided free of charge at no cost to your company!

1. A bid bond is not a formal or legal commitment from your surety company that they will issue a final performance and payment bond.
2. If you have been provided a bid bond and are unable to procure final bonding you will be penalized the amount of your bid bond. This penalty is to be paid by YOU not the bonding company.

There are a variety of situations that can arise when a surety will not be forthcoming to issue a final performance and payment bond that puts the bid bond (security) at risk. Some examples are as follows:

A. The contractor submitted a bid with a contract value in excess of the approved amount by the bonding company when the bid was formally presented for approval.

B. There is a significant bid spread or differential between the other contractors who also bid the project. As a rule of thumb, 10% is the guideline and any spread exceeding that amount is subject to surety review.

C. There is a negative change in financial condition from the time the bid is submitted and the final bonds are required. The surety may elect not to issue the final bonds upon discovery of this changed condition putting the bid bond at risk.

D. Upon review of the final contract documents prior to issuance of the final bonds, information surfaces that was not presented at the time the bid was submitted and approved by the bonding company. For example, if the contract contains a multiyear maintenance or warranty provision. Any guarantee beyond two years can be of significant concern to a surety company.

Another issue of great importance is the liquidated damage provision in the contract that may have not been fully understood or revealed at the time of bid approval. Whenever an owner states a specific project completion date and advises that a specific dollar penalty will be assessed if the scope of the project that you are being bonded for is not met by that date, a financial penalty can be levied. These damages can be significant in scope and could severely impact the net worth and/or working capital position of the contractor. Gambling casinos and student dormitories are examples where construction contracts often have very large liquidated damage clauses.

Of equal concern, is the absence of a liquidated damage clause. A contractor may be presented with a contract that has no specified damage if their work is not done on time. The danger is that the contractor could be liable for actual damages which could be very consequential. A least with a stated damage penalty, all parties involved understand the potential downside upfront and can plan accordingly.

E. There are onerous performance and payment bond forms being required by an owner or general contractor. Very prevalent in private construction, bond forms other than the traditional AIA 312 documents are being required. If a bidder misses this requirement upon their initial review of the contract, problems can result. The major item of interest is the amount of time a surety company is provided to properly review a claim notice filed against their bond. Many sureties oppose any unreasonable review period which is usually 15 days or less.

F. On private construction projects, there is often a burden of proof to provide the adequacy of project financing before any final bonds are issued. This often can be difficult to obtain especially when construction funding is "out of pocket" and not provided by a third party financing company. Bonding companies have encountered numerous situations where they are faced with payment bond claims from unpaid contractors, laborers or material suppliers because there was not enough money available to complete the project. It is always critical to understand payment terms prior to becoming a signatory to any construction contract. The reality of "pay when paid or paid if paid" can have dire consequences.

G. An inability to meet required underwriting conditions imposed by the bonding company at the time of the bid bond issuance that would have to be met prior to the execution of any final bonds. Often, a surety will insist on the bonding of major subcontractors, require the infusion of additional capital into the company and /or confirm project funding. An inability or unwillingness to meet these requirements would stop the issuance of the final bonds and again put the bid bond at risk.

As evidenced, there are a number of situations where a bid bond is at risk along with a contractor's capital. There does not appear to be an adequate understanding on the part of so many bidders that their company's assets are at risk with every bid bond submitted; the larger the job, the larger the risk. Why then is there often such a cavalier approach to this issue?

1. There is no charge for a bid bond. Since they are 'free'and sureties only charge a premium when a final bond is issued their importance is often unappreciated.
2. An assumption that a surety will automatically issue the necessary performance and payment bonds because that's how a bonding company makes their money.
3. There is so much "paperwork" involved in any construction project or contract venture that the bid bond is considered routine and "harmless". Every project has specifications, contracts certificates and disclosures that are required at the time of the bid. Too often a bid bond requirement is viewed only as another piece of paper without consideration of its significance.
4. A lack of knowledge as to just what a bid bond really represents. What you don't know can really hurt.

As a surety professional for over four decades, here are some real examples to remember:

Case #1 A contractor requested a "sunshine" letter from their bonding company to be used for marketing purposes, to describe their bonding limits under perfect circumstances. (The letter is carefully worded not to be a specific commitment). The contractor submits a bid bond request in the 1.5 million dollar range for their traditional construction work. The 10% bid bond requirement is approved by their surety company and the contractor proceeds with the bid submitting their proposal on a public construction project at an amount a little over three million dollars. The contractor is the low bidder, satisfied with their bid and needs work! The bonding company however, is shocked by the bid amount, almost twice the authorized amount and immediately reviews the contractors financial statement and promptly replies that they will not issue the final bonds because of the unapproved bid amount at 3 million. The contractor now has a 10% of $3,000,000 or $300,000 at risk if a final bond cannot be provided. The contractor immediately responds thinking the 3million would be authorized because of the "sunshine" letters he had received indicating that three million was within reason for a company of his magnitude .He immediately notifies his attorney regarding the surety's declination. The review of the "letter" by his legal counsel reveals no actual commitment from surety. He is now at risk of losing the $ 300,000 bid bond penalty that would severely harm his business. The municipality that received the bid is also disappointed because they will now have to turn to the second bidder's price which is higher and will cost more to pay for the project than originally expected!

As it turned out, the project owner realized that the contractor would be forced out of business in having to pay the $300,000 bid bond penalty. They certainly felt however that they were entitled to some financial relief because of the inability of the low bidder to obtain final bonding and enter into a construction contract. A negotiated settlement resulted with a lower penalty agreed upon to be paid to the municipality over several months. This agreement would keep the contractor in business and prevent the loss of local jobs had he been forced to cease operations. Good political relationships were helpful in this situation; however the contractor suffered severely for his lack of understanding.

Case #2 A contractor was bidding on their largest project ever. The $5,000,000 job was a public project requiring a 5% bid bond. The job was originally estimated to be in the 4 million dollar range but as the estimating process continued, the bid value increased to 5million; with the additional increase in cost submitted and approved by the surety company. (The exact opposite of case #1). The contractor went forward with their bid and was the low bidder. Unfortunately however, there was a huge bid spread between the low bid and the other contractors who also bid the job. The surety company's reaction to this huge bid spread was immediate and they were concerned that an error had been made in the low bid which would account for the staggering difference in the bid results. A "recognizable" error could be used as an excuse to allow the low bidder to withdraw their bid without having to forfeit their bid bond and pay the $250,000 penalty it would represent. (5% of $ 5,000,000 is $250,000)! The contractor had made no error and wanted the project to move forward and have the surety company authorize release of the final bonds so that a contract could be signed. The surety however, after completing their own in-house analysis of the contractors bid declined to authorize the final bonds. The contractor would now have to pay the $250,000 bid bond penalty, which was an amount that they could not pay and would force them to close their business. Every effort was made to persuade the bonding company to move forward and approve the final bonds but was not successful.

As it turned out in this case, there was only one "happy ending" possibility. The project owner decided to reject all bids and cancel the project entirely and have it redesigned and put out to bid at a later date. As such, all bid bonds were returned to the bidders and a capable contractor was not forced out of business over a bid bond issue. A case where being lucky can sometimes be better than being good!

Case #3 A contractor bid on a state funded project with an estimated contract amount of $1,200,000.00. The contractor was approved by surety and was the low bidder. In this case, there was again a large bid spread between the first and second bidders. Unlike the situation is case #2, the surety would support the issuance of the final bonds due to the significant financial strength of the contractor. The contractor however approached the State and requested that they be relieved of their bid asserting that an error had been made in their estimate which resulted in the large bid spread among the bidders. The State however, would not allow relief and refused to allow the contractor's bid bond to be returned without penalty and demanded that a contract be signed and final bonds produced.

In this situation however, the contractor decided that it would be better off paying the bid bond penalty, 5% of $1,200,000 which was $60,000, rather than go forward with the project that they felt would lose $200,000.00! Once again, another example of the magnitude of understanding the importance of bid securities.

In conclusion, the following should always be considered whenever a bid bond is required:

1. Can the bidder afford to "lose" the bid security amount if for whatever reason they do not enter a formal contract?
2. Is there a complete understanding of all contract requirements and how they could impact a surety's underwriting decision?
3. Do business with an experienced surety professional that can guide you through bid bond concerns.