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Information Memo

School Districts

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Use of Surety Bonds for School District Construction Projects

A surety bond is a guarantee under which a surety company promises to pay an obligee, or school district for purposes of this informational memorandum, if the principal, or general contractor, fails to perform certain obligations stated in the bond. Typically, if the general contractor performs its obligations in full, it is released from further liability. However, if it fails to perform the obligations set forth in the bond, both the general contractor and the surety each become liable to the school district for the full amount payable under the bond. There are three types of surety bonds that school districts in New York State must require in connection with construction contracts for capital improvements on district property.

Payment Bonds

School districts must require a general contractor to obtain a payment bond to secure the contractor's obligation to pay all money due to subcontractors, laborers and materialmen who perform work on a construction project. The purpose of a payment bond is to protect the district against claims by unpaid parties and to facilitate payment for labor and materials in connection with the project, thereby ensuring the continued performance of subcontractors and suppliers. The amount of a payment bond must be enough to cover the anticipated costs of labor and materials.

Section 137(1) of the New York State Finance Law provides the statutory requirement for a bond to secure payment of certain claims arising from public improvements. Specifically, it requires the use of "a bond guaranteeing prompt payment of moneys due to all persons furnishing labor or materials to the contractor or any subcontractors in the prosecution of the work provided for in [public construction contracts]" where the aggregate amount of a contract is over one-hundred thousand dollars. The State Education Department's Office of General Counsel has determined that this section of the Finance Law applies to construction contracts let by school districts. Additionally, Finance Law § 137(2) requires school districts to keep copies of all payment bonds issued for every capital improvement project constructed on district property, and it requires districts to make these bonds available for public inspection.

Performance Bonds

In addition to a payment bond, school districts should require a general contractor to obtain a performance bond to secure the contractor's obligation to perform its work in accordance with the construction contract. The purpose of a performance bond is to protect the district in the event that the general contractor defaults by failing to complete its work or by rendering defective performance. The amount of a performance bond is usually equal to the price of the prime contract, and this amount typically increases when add change orders are issued for the project.

School districts are not required to use performance bonds under Finance Law § 137. However, districts are advised to use them, and sureties often charge a single premium for both payment and performance bonds. When a school district chooses to use a performance bond in connection with a construction project for which state aid has been granted, the district must provide certain information concerning the bond to the New York Department of State or the agency responsible for supervising the aid program pursuant to sections 103-f of the General Municipal Law and 139-e of the Finance Law.

Bid Bonds

School districts should also consider requiring bid bonds, particularly on large capital improvement projects, to secure the obligation of a successful bidder to enter into the contract for which it submitted a bid. The purpose of a bid bond is to protect the district in the event that the successful bidder refuses to enter into the contract. A bid bond is valid only for the bid specified in the bond; subsequent bids, even for the same project, require additional bid bonds because they are new obligations of the bidder.

If a successful bidder fails to enter into the contract and the school district obtained a bid bond, then the bidder is liable to the district for the difference between the amount of its bid and any larger amount for which the district, in good faith, contracted with another party to perform the work specified in the bid, up to the amount of the bond.

Licensing and Rating

Sureties that are licensed to conduct business in New York State must meet certain standards set forth by the State Insurance Department which is responsible for assuring the financial integrity of insurance and surety companies that operate in New York. School districts must use sureties licensed by New York State, because if a State licensed surety fails to pay the amount due under a bond, the district would be protected by New York's Property/Casualty Insurance Security Fund. Furthermore, school districts should independently verify the financial stability of the surety companies with which they conduct business. A district may do so by reviewing the ratings of sureties published by the A.M. Best Company or Standard and Poor's. School districts are advised to use sureties with an A.M. Best rating of "A" or better to issue bonds for capital improvement projects on district property.

Forms

Popular form construction contracts, such as those published by the American Institute of Architects ("AIA"), typically state in general terms that the contractor must obtain surety bonds in specified amounts and that the bonds must be issued by a surety company acceptable to the project owner, the general contractor or another obligee. The specific terms of each surety bond are set forth in bond forms provided by the district and attached as appendices or exhibits to the contract. These surety bond forms provide the rights and obligations of the parties. In addition to form construction contracts, the AIA also publishes surety bond forms, the most current versions of which are the AIA 312 - 2010 for both payment and performance bonds, and the AIA 310 - 2010 for bid bonds.

Premiums

When school districts require surety bonds, it is the general contractor's responsibility to obtain them and to pay the premiums, which are usually due upon execution of each bond. Accordingly, the general contractor is likely to include the cost of obtaining required bonds in its bid for the project. Surety bond premiums often range from about one-half to two percent of the contract amount but will vary depending on factors such as the size, type and duration of the project and the credit of the contractor.

Enforcement

Finally, if a school district needs enforce its rights under a surety bond issued in connection with a district construction project, it must follow the exact procedures provided in the bond. For more information regarding enforcement or any other information about surety bonds, please contact a member of Bond's School District Practice Group listed below:

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