



The Surety & Fidelity Association of America Statement Concerning Bonding Long-Term Warranties

Introduction

Over the last few years, state departments of transportation (“DOTs”) have been turning to innovative contracting techniques in order to meet the growing demand to construct and maintain high-quality and safe highways. Historically, state funded inspections and materials testing have been the primary means to ensure high-quality roads. However, states recently have experienced reduced personnel levels and reduced funding which negatively impacted the extent of quality assurance activities undertaken by state DOTs.

To address this challenge, states have implemented warranty requirements in connection with highway construction contracts. In essence, the warranty requirements serve as supplements to the reduced inspection and materials testing activities by operating as a mechanism for enforcing quality requirements. Under these warranties, the contractor is responsible for correcting defects in its work that are due to faulty materials and workmanship (materials and workmanship warranty) or correcting any shortfall from established specifications regarding the road surface (performance warranties). It is often difficult to determine where the line is between faulty workmanship and materials versus inadequate design or road use beyond expectations. Recently, some states have implemented, or considered the implementation of, warranties with durations as long as 20 years.

States have required bonds to secure the faithful performance of the contractor’s obligations during the warranty period. The surety industry understands the desire for quality assurance. However, long-term warranty bond requirements limit bond availability, thereby limiting competition for highway construction contracts, and ultimately increasing costs. The Surety & Fidelity Association of America (“SFAA”) offers a proposal to establish a bond requirement that would be available more widely.

Increased Risk, Reduced Competition and Increased Costs

When a surety writes a bond for a contractor, it is making a judgment about the contractor’s financial and operational viability. As the duration of the bonded obligation becomes longer, and the surety must assess the contractor’s operation for periods of time well into the future, the certainty of the judgment may be lessened. This is the case with a warranty bond that has a long-term duration.

In addition to the uncertainty involved in underwriting a contractor far into the future, the method of payment for the work under the warranty also increases the risk to the surety. As the contractor progresses during the construction period of the project, the contractor is paid only for work put in place. If the contractor defaults and the project is incomplete, the balance of contract

funds should be available for the surety to complete the project. However, under most contracts, the contractor is paid fully upon final completion, leaving no contract balances to fund any warranty work. Therefore, if a surety must step in to complete the warranty work, it does not have any contract funds available to mitigate its loss.

To compensate for the increased risk due to the diminished certainty of underwriting and the method of payment, sureties typically raise their underwriting standards, and provide long-term bonds only to the largest and most financially sound contractors. Many smaller contractors who are fully qualified to do the work would be precluded from bidding on these projects. If sureties raise their underwriting thresholds high enough to address the risks and uncertainty of an obligation lasting 10, 15 or 20 years, very few contractors, if any, would qualify for the required warranty bond. As a result, fewer contractors compete for the project, which may cause an increase of bid prices and construction costs.

A long-term warranty also increases the surety bond costs. According to the SFAA Manual of Rules, Procedures and Classifications, a premium is charged for each year beyond the first warranty year.

Recommendation

The SFAA believes that a workable bond requirement can be established which provides effective protection to state DOTs, presents a reasonable risk to the sureties and enhances competition among responsible contractors. SFAA recommends that the warranty be limited to three years. With adequate design, engineering and inspection this length of time protects the owner but does not subject a contracting company to financial hardship for defects which are out of its control.

The amount of the warranty bond should be 10% of the final contract price, and required to be submitted at final acceptance of the construction project. The release of the performance bond would be conditioned upon the receipt of the warranty bond.

SFAA invites dialogue with contractors and state DOTs to develop a bond requirement that would be more widely available than a long-term warranty bond and would enhance competition.