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3. Surety Bonds Versus Letters of Credit

WASTEC is introducing a new member benefit, a surety bond program that can save you money and get you more bonding capacity for your premium. Here's one way surety bonds can help your company.

For companies in the solid waste and recycling industry, it's important to understand that surety bonds differ considerably from letters of credit. The question of whether a letter of credit is a suitable substitute for corporate surety bonds to guarantee a company's performance, along with the payment of certain subcontractors and suppliers, has confronted legislators, government officials, and private owners for many years.

Letters of credit, strictly a financial transaction with amounts callable by the owner *upon demand*, are frequently viewed as a substitute for performance and payment bonds. A company will be asked to pledge specific assets to secure bank letters of credit, while surety bonds are issued on an unsecured basis and provided on the strength of corporate and personal signatures of the owners of the company.

Prior to issuing a performance and payment bond, the surety tries to make certain that your company has adequate financial resources, the necessary experience, and management skills to carry on the business and successfully complete the contract for which the bond is required. Most surety companies issue bonds through knowledgeable surety bond producers, also called agents or brokers. By contrast, when issuing a letter of credit, the banker will probably only be interested in the adequacy of the collateral available to the bank in case there's a call on the letter.

The critical difference between surety bonds and letters of credit becomes very clear at the time of default. The surety company has duties and responsibilities to both the contractor and the owner. Before paying anything, and only after investigating the default to verify its validity, the surety may then step in and finance the original contractor or provide other support necessary to allow the contractor to finish its contract. Or, the surety may arrange for a new company to come in and perform the contract…or, have the project owner award the balance of the contract to another company with the surety agreeing to pick up any difference in cost. If none of the aforementioned alternatives prove feasible, a surety may pay the sum of the bond.

On the other hand, with letters of credit, upon default all the bank will do is pay the owner *on demand* the amount of the letter of credit. A letter of credit does not guarantee sufficient funds to complete the contract, pay suppliers, etc. Most importantly, bank letters of credit diminish a company's existing line of credit and are reflected on a company's financial statement as a contingent liability. Having assets tied up, or an available line of credit diminished – especially in today's current banking environment – is counterproductive. A company's cash flow, especially in the initial stages of a contract, can be adversely affected when liquid assets are pledged to a bank or the bank reduces its borrowing capacity as a result of the issuance of a letter of credit.

Letters of credit are simply no substitute for surety bonds. Surety bonds are a better instrument for companies in the solid waste and recycling industry, and the owners/ municipalities they serve. For more information about surety bonds, contact Art Colley of Nielson, Colley & Associates at acolley@nielsonbonds.com or 704-362-3991.