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CONSTRUCTOR

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BUILDING YOUR QUALITY OF LIFE

CREATING VALUE FOR AMERICA

AGC President Jack Kelley of Nickerson & O'Day Inc., Brewer, Maine

SUBCONTRACTOR BONDING

EVERYTHING YOU SHOULD KNOW ABOUT THIS IMPORTANT AND TIME-HONORED RISK-MANAGEMENT STRATEGY

The construction business involves considerable risk, especially when it comes to identifying, assessing, and managing risk on subcontractors. Subcontractors are vital to project completion, and an unqualified subcontractor can have a major impact on your project.

Contract surety bonds are an effective tool for shifting the risk of subcontractor failure to a surety company. Surety bonding is a careful, rigorous, and professional process by which the surety prequalifies the subcontractor and supports that judgment by issuing performance and payment bonds.

❑ Performance bonds help assure the subcontractor is qualified to perform the work, and protect the prime contractor (obligee) from ultimate financial risk should the subcontractor (principal) default or fail to perform the job according to the terms and conditions of the contract.

❑ Payment bonds assure that specified laborers and suppliers associated with the project will be paid.

Benefits of bonding subs. Transferring the risk of subcontractor default to the surety company is just one of the benefits of surety bonds. When prime contractors require performance and payment bonds from their subcontractors:

❑ They receive increased assurance of having qualified subcontractors. This pre-bid requirement elevates the quality of subcontractor bids, and eliminates problems that may occur with lesser quality or unqualified subcontractors.

❑ They are protected from paying twice for the same work items if the subcontractor fails to pay its subcontractors and suppliers.

Prime contractors with established subcontractor bonding programs are generally viewed favorably by their own surety company.

The Prequalification Process. Prequalification is one of the most important services of the surety industry. It is a thorough process in which the surety evaluates the subcontractor on the following points:

- ❑ Business operations;
- ❑ Financial strength;
- ❑ Experience and reputation;
- ❑ Subcontract documents;
- ❑ Exposure and progress on other contracts (bonded and non-bonded);
- ❑ Size and location of the work; and
- ❑ Ability to perform that work.

Indemnification. Most surety companies require indemnity from the contractors and subcontractors they bond. This may include personal indemnity of the owners in addition to the guarantee of the contracting entity. A troubled subcontractor is more likely to complete bonded jobs because business assets, and possibly personal assets, are on the line. This factor alone may provide the prime contractor with the leverage to keep the subcontractor performing on the job.

Availability of Surety Bonds. Surety bonds are available for qualified subcontractors. Traditional surety companies bond all types and sizes of contractors and subcontractors. However, in today's market, some surety companies are focusing on specific niche markets, including small and emerging contractors. Also, the U.S. Small Business Administration (SBA) Surety Bond Guarantee Program offers guarantees for performance and payment bonds issued by participating surety companies to small and emerging contractors who have difficulty obtaining surety bonds through regular commercial channels.

Prior to bid, prime contractors can require a letter from the subcontractor's surety indicating its ability to provide subcontract bonds on the project in question.

For subcontractors facing a long lead time before they actually start work, obtaining a commitment letter from their surety may be more difficult. In those situations, the prime contractor may have to settle for a letter containing language about the availability of bonds being subject to underwriting conditions at the time the bond is needed.

Occasionally, subcontractors may not have enough surety capacity to provide a bond on an entire contract. They may ask the prime contractor to purchase the materials and equipment and execute a labor-only contract in order to be in a position to provide a bond. This type of situation must be considered very carefully. Recognize that there is a reason the surety company is unwilling to execute a larger bond.

The same thing is true of phased contracts where a bond may be issued for each phase of the project. Receiving a bond on the first phase of a contract is no guarantee that a bond will be available on the second phase.

Qualify the Sub's Surety. There is a wide array of surety companies in the marketplace, and it is a good idea to investigate the quality of a subcontractor's surety. There are several sources that rate insurance companies including A.M. Best, Standard and Poors, Moody's, Fitch Ratings, and Weiss Ratings.

In addition, the U.S. Department of the Treasury publishes a list on July 1st of every year that names the corporate

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NEED MORE INFORMATION ON SURETY BONDS?

The Surety Information Office (SIO) has an array of resources available to help you establish or build a successful surety program. SIO offers:

- ❑ Free Surety Bonds for Contractors CD;
- ❑ Free printed materials on many aspects of bonding;
- ❑ Free educational PowerPoint presentations;
- ❑ A special "Contractors/Subcontractors" resource area at www.sio.org;
- ❑ Assistance locating and working with a professional surety bond producer;
- ❑ Insight into qualifying a surety company; and
- ❑ Speakers for your local association or company meetings.

Contract surety bonds are a vital aspect of a contractor's business operation. Contact SIO at (202) 686-7463, sio@sio.org, or www.sio.org.

sureties that are qualified to write bonds on federal projects. This list is titled Department Circular 570, also referred to as the "T List." It lists each qualified surety and contact information, the states in which it is licensed to do business, and underwriting limitation on a per bond basis. Sureties must protect individual bonds written in excess of the underwriting limitation with co-insurance, reinsurance, or other protection in accordance with Treasury regulations. Not every surety chooses to write bonds for federal contracts and, obviously, those sureties will not be on the T-List.

State insurance departments regulate and license companies that write surety bonds and can provide information on these companies. Most state insurance department websites include a list of surety companies licensed to do business in that state. The National Association of Insurance Commissioners (NAIC) provides contact information for insurance departments in all 50 states.

In addition, check with your surety bond producer or surety company as to the sureties' reputations. For more information on the ratings organizations and to access the Treasury list and state insurance departments, go to http://www.sio.org/links_page.html.

Cost of Bonds. Surety rates vary depending on the type of construction, the surety company, and the subcontractor. Surety bonds typically cost from one-half of one percent to three percent of the contract amount. Surety bonds issued through the SBA Surety Bond Guarantee Program are assessed an additional 0.6 percent fee. When issued concurrently with a performance bond, the cost for a payment bond is usually included in the performance bond charge. With bond premiums based on contract amounts, it makes sense to require 100 percent performance and 100 percent payment bonds. The cost is typically the same as for a lesser percentage and the bonds provide maximum protection to the prime contractor.

Communicate With the Surety. Most surety companies monitor the progress of the subcontractor by routinely sending out job status inquiries to the prime contractor. Although at times it may seem like unnecessary paperwork, it can be an effective means of communication with a subcontractor's surety company.

Most of the time, the responses to these inquiries report satisfactory performance. However, in those situations where that is not the case, they can be an early warning of a looming problem. When a surety company is aware of a problem early on, it may be in a position to help the subcontractor and prevent the problem from becoming a major disaster.

The job status inquiry gives the prime contractor a reasonable means of communicating with a subcontractor's surety. Keep in mind that the prime contractor has a right, and in some cases, a duty, to communicate with the surety company about unsatisfactory performance of the subcontractor. That communication should be initiated by the prime contractor as soon as serious project performance problems with the subcontractor surface.

Dispute or Default? The subcontractor's performance obligations should be defined in the subcontract documents. Occasional disputes over responsibility for scope of work, resolution of problems, etc., are not uncommon, but do not necessarily constitute "default." Although a surety is not an arbiter of these disputes and has no contractual ability or legal standing to resolve them, most sureties will respond to the prime contractor and subcontractor when they are notified of potential problems or receive a negative status report when they appear to materially affect the overall project. The earlier the surety knows of the problem, the sooner it can get involved. The surety may be able to offer assistance to resolve the situation before a formal default is made.

If the surety is unable to help the subcontractor resolve the situation, default may be unavoidable. If default occurs, the prime contractor must file a formal declaration of default in writing to the surety company. The surety must acknowledge the claim, investigate the claim, and then determine and fulfill its obligations.

The surety has several options as to how it responds to the claims on the bonds. It may:

- ❑ Maintain the present subcontractor and provide technical or financial assistance to complete the project;
- ❑ Remove the current subcontractor and bring in a replacement subcontractor to finish the contract; or
- ❑ Negotiate a financial settlement with the prime contractor and issue a check.

Establish a Bonding Policy. Many sureties may encourage prime contractors to bond subs—especially on large, complex projects, or when a few subcontractors represent proportionally large or critical segments of the work. In addition, sureties encourage prime contractors to establish a subcontractor bonding policy because the cost and risk of subcontractor failure negatively affecting the completion of the prime contract is reduced.

The first step to establishing a bonding policy is to set a threshold at which bonds must be required. Thresholds may be set as a dollar amount, e.g., all contracts over $50,000; or they may be set as percentage of contract, e.g. all subcontracts for 10 percent or more of the overall work.

Once a bonding policy is established, the prime contractor should notify its subcontractors of the policy as well as its surety bond producer and surety underwriter. Other considerations when establishing a universal bonding policy should include:

- ❑ Type and complexity of work;
- ❑ Duration of the subcontract;
- ❑ Bid spread;
- ❑ Size of subcontractor;
- ❑ Subcontractor's reputation;
- ❑ Government regulation;
- ❑ Subcontractor inexperience with type of project or geographic area;
- ❑ Subcontractor role as a key part of contract; and
- ❑ Multiple project exposures with the same subcontractor.

A well-thought out bonding policy for subcontractors provides you with many benefits, including the prequalification services of the surety, the effects of indemnity, the positive impact on your own surety relationship, and the ultimate performance and payment protection offered by the bonds.

— By **Marla McIntyre,** *executive director of the Surety Information Office (SIO), Washington, D.C.*

FOR MORE INFORMATION

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