The Value of 100% Contract Surety Bonds

Construction is a high risk endeavor. So, good construction risk management must account for the potential of a contractor default. Surety bonds are designed to transfer the risk of loss stemming from such a default onto the surety and away from project owners and other stakeholders. This is achieved through performance bonds, which secure a contractor's performance of the contract work and payment bonds, which secure a contractor's payment to its subcontractors and suppliers.

Importantly, a bonded contractor is prequalified by its surety as capable of performing the contract. Prequalification often entails a surety's rigorous investigation of the contractor's financial strength, historical and projected future capacity to complete projects, and even its reputation in the industry. This underwriting helps minimize the likelihood of a contractor default.

Unfortunately, unforeseen adverse events can impact projects, contractors, and the economy. The risk of default can never be completely eliminated. Requiring full protection is the most effective method to get a project delivered on schedule and on budget, even in the face of a contractor default. With 100% performance and payment bonds sureties often even finance contractors and prevent default!

Federal, state, and local procurement laws recognize the importance of surety bonds as a tool to protect project funds and to secure payment for subcontractors and suppliers. Public entities require performance and payment security for the vast majority of public works. Private owners and developers also protect themselves and their projects by requiring surety bonds.

What should the size of the surety bond be? For public works, the minimum bond amount most often is predetermined by law. On private projects, or on public works where discretion is permitted, it is critical to require a bond in an amount sufficient to fully secure the contractor's performance and payment obligations through the entire contract. The amount of the bond is called the penal sum and the requirement typically is expressed as a percent of the contract amount. The penal sum stated in the bond is the highest amount the surety will pay to assure contract performance and payments after the remaining contract funds held by the owner are spent.

Surety bond premiums are priced on the full contract price, not the bond's penal sum. Bonds secure the full performance of the contract. Therefore, the contract price represents a measure of the surety's risk. Generally, therefore, no cost savings are realized from requiring lower penalty bonds verses 100% performance and 100% payment bonds. Without doubt, 100% bonds provide superior value.

Significant payment and performance protection can be achieved with 100% performance and payment bonds. The full contract value is available to cover the excess costs of contract completion and, in most instances, an additional 100% of the contract value is available to pay the claims of subcontractors and suppliers. With 200% of the contract value available to protect performance and payments, sufficient resources are also available for remobilizing a project, accelerating delayed work, and liquidated damages, if applicable.

Low penalty bonds (typically those of 50% or less of the contract price), on the other hand, may not provide sufficient funds to actually complete the contract or pay all valid claims. The further a performance bond's penal sum is reduced, the greater the likelihood it will be insufficient for the surety to finance the contractor's cash-flow or fund it to contract completion, hire consultants, or absorb the total cost to obtain and mobilize a replacement contractor. The lower the penal sum of the payment bond, the more likely subcontractors and suppliers will increase their prices to mitigate the increased potential of loss if there is a contractor default, and walk off the project when payments are delayed.

Clearly, maximum payment and performance protection is best achieved with 100% bonds, while low penalty bonds limit the risk-mitigating and claims handling options that could otherwise be available. This trade-off is without any countervailing cost savings to owners. Whether a project is public or private, full surety protection is the most effective way to protect taxpayers, owners, lenders, investors, and other stakeholders from the risk of loss and delay caused by a contractor default.

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