Mitigating Risk with Surety Bonds

By Jace Pearson

As contractors seek to increase work programs with higher construction demands, their balance sheets – which were greatly impacted during recession years a decade ago – may not provide the liquidity necessary to keep pace with desired backlogs.

Today's project owners are more cautious than ever, and transferring more risk to general contractors through the use of surety bonds. GCs, concerned about the risk of subcontractor default, are protecting themselves by requiring a majority of subcontractors to provide surety bonds with the general as the protected party.

Understanding your obligations as a bond-holder, as well as knowing how to appropriately use bonds to transfer your own risks, is critical in today's environment.

Know Your Contract Responsibility

One of your biggest risks is entering into a contract you have not thoroughly read or understood. This is especially relevant when your client is requiring performance and payment bonds.

- **Owners are pushing risk to GCs.** Cautious owners are adding new terms to contracts that further increase your risk as a GC. For example, many owners now limit the time period sureties can investigate and respond to a claim. It is also common for changes to be made to the bond form, which extends the time period claims can be filed. When reviewing any contract, pay special attention to start and completion dates, payment terms, warranty periods, dispute resolutions, and liquidated damages that could result in daily payment penalties.
- **GCs are transferring risk to subs.** If you are a subcontractor entering into a contract with a GC, you must take multiple factors into consideration. The GC's subcontract can include "flow down" or "pass through" clauses that transfer contract obligations made between the GC and owner to you. These obligations likely include insurance, indemnity, payment, warranties, extras, liquidated damages, and dispute resolution. If you sign a contract with these unrestricted clauses, you are accepting whatever risks a GC has agreed to with the owner.
- **You have a lot at stake**. Once you sign a contract and provide the bonds, you are locked into all terms and conditions of that contract. Most sureties require you to provide both corporate and personal indemnity commitments in order to secure bonds, so not only are you putting your business at risk, your personal assets are at risk as well if you default.

Reducing Your Risk with Bonds

Subcontractors are critical to the success of most projects. Problems with a single sub can delay the work of others, potentially derailing the entire project. Surety bonds can assist in managing this risk.

In a survey conducted by construction management consultant FMI, 62% of surety providers report seeing an increase in the number of general contractors requiring performance bonds from their subcontractors. This trend will likely continue as surety providers encourage or even require prime contractors to obtain bond guarantees from their subs as a way to reduce the GC's own bond exposure.

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Risk Transfer

Contract surety bonds shift the risk of a subcontractor's failure to one or more surety companies. The bonding process assures the GC that a sub will perform all terms and conditions of the contract or other measures will be taken to protect the GC. This assurance is provided using two types of bonds:

- **Performance bond:** Guarantees the subcontractor will complete the contract according to its terms, including price and time.
- **Payment bond:** Guarantees the subcontractor will pay its suppliers and contractors.

Contractors may also want to consider bonding key material suppliers. This is especially important for lengthy projects, where price fluctuations could put a financial burden on the contractor. Asking a supplier to provide a bond will reduce both the GC's and subcontractor's risk, ensuring the supplier will provide the materials needed to fulfill the contracted obligations.

Subcontractor Screening

An added bonus of the bonding process, from a prime contractor's point of view, is the rigorous qualification process subcontractors must go through in order to obtain bonding. Requiring a sub to be » bonded can help screen out unqualified subcontractors.

Reputable subcontractors, in turn, will not object to being asked to provide surety bonds. In fact, a growing number of subcontractors, looking to expand their ability to get work, are engaging with sureties to build their bonding capacity.

GCs should check a subcontractor's bonding status as a standard part of their prequalification process. Bonding is especially important on large, complex projects or on jobs where a few subs represent proportionally large or critical segments of the work. Some GCs have a formal bonding process with set thresholds for when subcontractors must provide bonding.

When Defaults Occur

To detect signs of potential default early, actively manage subs and keep communication channels open. If things come up, take proactive steps to remedy the situation.

Contractors should also understand what steps need to be taken if a bonded sub doesn't meet obligations. When a subcontractor defaults, there are critical claim and notice requirements imposed by contract and by law. Working proactively with a lawyer to lay out a contingency plan that you can immediately put into action will save you money, liability exposure and keep the job running.

What to Look For in a Surety

Whether you're looking for a surety that can bond your own company or checking on your subcontractor's surety, make sure you do your due diligence. Two useful sources are A.M. Best and the U.S. Department of the Treasury, which publishes an annual list of sureties that are qualified to write bonds. Often referred to as the "T" list, it tells you which states the surety is licensed to do business in and the surety's underwriting limitations.

Most sureties distribute bonds through agents, who are also known as brokers or producers. A professional bond agent is your guide through the bonding process, helping you to select and build a relationship with a surety that best fits your needs. It's important to select a surety agent that has your best interest in mind. Look for an agent who:

- Has a reputation for integrity and quality service.
- Is experienced in the construction industry.
- Understands construction contracts, finance, strategic planning, and successful management practices.
- Has built solid relationships with respected surety underwriters.
- Is actively involved in local and national construction industry associations.

A reputable surety agent and company can be a key partner in managing your risk and can serve as key advisors, helping you spot issues, improve processes, and build a stronger business. ■

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