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When Should a General Contractor Require Subcontract Bonds?


BY DAN POPE

The key to the decision is balancing the GC's risk from subcontractor default with profit from the project.

Changes related to the COVID-19 crisis and the construction and surety industries are still occurring; some data in this article may have changed from the time of article submission and the publication date.

WHEN CONSIDERING SUBCONTRACTOR risk on a project, a general contractor (GC) faces a series of questions and decisions. Among them are the following:

- What subcontractors are critical to maintaining the construction schedule?
- Is there limited availability of specialty trade contractors?
- Are there disadvantaged contractor participation goals?
- Is the construction project location new to the GC and are the subcontractors unfamiliar?
- Is the pool of skilled labor in the area limited?

Perhaps most importantly, are the GC's own resources adequate to withstand the disruption of a subcontractor default? To manage the risk, general contractors should have a systematic approach to choosing subcontractors.

Prequalification is Key

Developing a rigorous prequalification process to identify suitable subcontractors is a key step. Well-established subcontractors who have performed similar work may pose less risk than those who are less familiar with the type of subcontract work needed. Credit reporting services such as Experian or Dun & Bradstreet can provide insight into the subcontractor's financial situation.

Subcontractors, however, work for several GCs and owners. Can a GC be certain a subcontractor that otherwise qualifies is not overcommitted or mired down on a troubled project?

Requiring a bondability letter on surety company letterhead would indicate that a surety, privy to the financial condition of the subcontractor, thought generally well enough of the subcontractor to be likely to provide a bond if required. A bondability letter indicates the subcontractor has a surety relationship but is not binding on the surety for a specific project.

While the prequalification process quickly narrows the field, prequalification alone provides no guarantee of a subcontractor's performance. The next step is to consider more certain risk mitigation.

The requirement of a subcontractor bid bond is a project-specific guarantee that the subcontractor will enter into the subcontract for the amount bid. Yet bid bonds alone do not provide a guarantee of the subcontractor's performance.

Performance and payment bonds do provide a guarantee of the subcontractor's performance. The bond cost will generally increase the subcontractor's bid by 1–3%. This is in essence a financing of risk. The bond removes the risk of subcontractor default from the general contractor and transfers it to the subcontractor's surety company.

Subcontract Bonds Respond to Defaults

The subcontract bond surety would respond in the event of a subcontractor default. This likely entails the completion of the defaulting subcontractor's obligations under the subcontract by another trade contactor procured by the subcontract surety. While any subcontractor default, bonded or unbonded, may disrupt the construction schedule, the subcontract bond provides an avenue of recovery for damages or loss caused by default. The GC must then decide what the parameters are for the bond requirement.

There are different approaches to subcontractor bonding requirements. One approach is to bond all subcontractors with subcontract prices above a certain dollar threshold. Or the GC may choose to bond only those subcontractors that are critical to maintaining the construction schedule.

Finally, the GC may wish to bond those specialty subcontractors and disadvantaged contractors that may not have large subcontracts but whose required status and services may be difficult to re-procure if they fail. The GC must weigh the additional cost of subcontractor bonds against its competitive position in a bid situation and impact to the final profit margin on the job.

When estimating a project, the GC must find the right balance between risk mitigation measures, including subcontract bonds, against the opportunity for profit on the job. However, the GC should also consider the enterprise risk posed by a subcontractor default. The relatively low cost of a subcontract bond provides the opportunity for greater recovery in the event of a default, and it provides a greater certainty of a successful outcome on the overall project for the continued profitable operation of the GC enterprise.

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