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Bonding Protects Investments in Private Construction Projects

A recent opinion article by a construction company questioned the necessity of bonding on private construction projects, saying that proper contractor selection may eliminate the need for bonding. Indeed, contractor prequalification is vitally important on any construction project, as, in the words of the construction company, "[c]onstruction is inherently complex, and challenges will arise." It is precisely that point that gave rise to the prevalent use of surety bonds on the Nation's construction projects for well over a century.

Prequalification and guarantees of performance are the hallmarks of construction surety bonds, as the surety company performs a thorough and critical evaluation of the construction company seeking surety credit in the form of bid, performance, and payment bonds. This assessment goes well beyond what might be done by project owners and general contractors, assuming they have the expertise, resources, and time availability, as the surety prequalification process is continuous and expansive. It is continuous because bonds are underwritten specifically for each contract; it is expansive because the surety's interest in its bonded principal extends well past the business's financial wherewithal to the business's current business plan, its succession plan, its management capabilities, its equipment, its reputation among peers and clients, and its overall program, among other matters, giving the surety a comprehensive and on-going understanding. With that understanding, the surety extends credit solely to the business it believes will perform its contract obligations successfully. Because surety bonds are means to avoid project defaults in the first instance by assuring that only a qualified, vetted company is extended credit in the form of the performance and payment bonds, surety bonds should be considered proactive, not reactive, steps by private owners and savvy general contractors to mitigate risks on construction projects.

Private project owners should know that construction bonds ensure that bonded contractors and subcontractors have "skin in the game." As a condition of receiving surety credit, bonded principals must execute personal and corporate indemnity agreements in favor of the surety, so that the surety can recover the amounts the surety pays out on behalf of the defaulting principal. These indemnity agreements provide powerful leverage so a contractor or a subcontractor cannot simply walk away from its contractual obligations, absent legally justifying circumstances. Private owners also should recognize the advantage of early communication with sureties furnishing bonds on their projects if and when problems arise, as it is in the best interests of sureties to assist troubled principals to prevent problems from escalating to contract defaults.

The presence of a payment bond on a private construction project provides additional benefits to private owners, as it conveys assurance to subcontractors and suppliers that they have a means of getting paid should the general contractor fail to pay them. The presence of the payment bond makes the project more attractive, especially to key trades, and benefits the project through the avoidance of additional contingencies and of liens.

The findings of a recent study undertaken by the accounting and consulting firm Ernst & Young validate the economic benefits of requiring surety bonds for construction contracts. Prepared for The Surety & Fidelity Association of America, the study found that bonded projects had a lower rate or likelihood of default and that bond requirements improved or lowered contractor pricing. The study also found that unbonded projects which experienced a contractor default had significantly higher costs of completion than bonded projects. The study can be accessed at https://surety.org/suretyprotects/.

Bond premiums do add approximately 1% or more to the construction contract--not project--cost, but the combined performance and payment bonds typically provide 200% coverage of the contract amount. With today's construction environment facing continuing inflation and material price escalation, workforce shortages, and the specter of tariffs on supply chains, is forgoing the risk transfer benefits of surety bonds on private construction projects really a prudent risk management decision? What is peace of mind worth to you, as a private project owner, when you are risking your community reputation and precious capital in the inherent uncertainties of a construction project undertaking?