Should Subcontractors be Bonded?

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Savvy owners know that requiring performance and payment bonds on a construction project can provide significant protection against the downside risk of a prime contractor’s failure to perform the work or failure to pay its subcontractors and suppliers. Performance bonds are obtained to ensure the contractor’s faithful performance of its contract with the owner, and payment bonds are obtained to ensure the contractor’s payment to third party “claimants” who furnish labor, material or equipment on a project. Savvy contractors should also consider requiring performance and payment bonds from their first-tier subcontractors to manage and allocate the risk that is inherent in any construction project and to protect against claims originating from second tier subcontractors and suppliers.

What is the difference between a subcontractor performance bond and a subcontractor payment bond? A subcontractor performance bond is a project specific contractual agreement between a subcontractor and a surety by which the surety guarantees to arrange for the completion of a subcontract if the subcontractor runs into trouble and fails to complete its scope of work on the project. A subcontractor performance bond is intended for the protection of the contractor. A subcontractor performance bond is different from a subcontractor payment bond in that a subcontractor performance bond is not intended to protect the subcontractor’s unpaid lower-tier subcontractors or suppliers. A subcontractor payment bond is a project specific contractual agreement between a subcontractor and a surety by which the surety guarantees payment for the labor and materials contracted for and used by the subcontractor on the project. A subcontractor payment bond differs from a subcontractor performance bond in that the subcontractor payment bond does not directly protect the contractor. Instead, it is a guarantee of payment that is intended to benefit and protect directly the subcontractor’s lower-tier subcontractors or suppliers if the subcontractor fails to pay for the labor or materials furnished for the subcontractor’s scope of work on the project. To the extent that lower-tier claims are resolved directly against the subcontractor’s payment bond, the contractor benefits indirectly. By requiring a subcontractor payment bond, the contractor shifts some of the project risk to the subcontractor’s surety.

What are some of the disadvantages of requiring subcontractor performance and payment bonds? In recent years, subcontractor bonds have become more expensive and sometimes more difficult to obtain. Thus, a requirement that subcontractors be bonded may limit the field of subcontractors who are qualified to submit competitive bids to the contractor. Another obvious disadvantage is cost. Requiring subcontractor performance and payment bonds will necessarily add an additional cost component to the contractor’s estimated project costs. The rates for subcontractor performance and payment bonds typically range from less than one percent to more than three percent of the subcontract amount. Note that in many cases the contractor’s own surety may require the contractor to bond its subcontractors. This is frequently the case on large, complex construction projects and for subcontractors performing large or critical scopes of work. In a competitive bid market, a
contractor’s decision to have its subcontractors bonded, or the contractor’s surety’s requirement for subcontractor bonding, may determine whether the contractor becomes the successful bidder.

What are some of the advantages of requiring subcontractor performance and payment bonds? The advantages of having the subcontractors bonded are many. For example, the surety will prequalify prospective subcontractors. Through its prequalification process, the surety will evaluate the financial strength of the prospective subcontractor. The surety will evaluate the subcontractor’s character, experience, and ability to perform the work. The surety will also evaluate the subcontractor’s progress and potential exposure on other unrelated contracts. As a result, the surety’s prequalification process will help the contractor weed out subcontractors that are not qualified to perform the work or that don’t have the financial strength to successfully complete the work. Most sureties require that the bond principal, the subcontractor in this instance, indemnify the surety for any losses under the bond. This is done through a formal contract known as a general indemnity agreement. By this agreement, the bond principal agrees to reimburse the surety for any costs incurred by the surety on behalf of the bond principal. The typical general indemnity agreement between a surety and a closely-held corporation requires personal indemnity from the corporation’s shareholders in addition to indemnity from the corporation itself. A subcontractor and the subcontractor’s shareholders who execute a general indemnity agreement risk both the corporate assets as well as the individual shareholders’ personal assets in the event that the surety pays a claim on the bond. Thus, if the subcontractor finds itself in dire financial straits, the subcontractor is more likely to focus its attention on its bonded jobs, sometimes to the detriment of its non-bonded jobs. Knowing that the subcontractor’s shareholders may be on the hook personally may provide the contractor with the leverage it needs to keep the subcontractor working on the bonded project.

Are there alternatives to bonding the subcontractor? There are some alternatives that may provide some assurance of the subcontractor’s performance without the added expense of performance and payment bonds. For example, the subcontractor may be willing to post a letter of credit in lieu of a bond. Also, an individual shareholder of the subcontractor, or a related business entity such as a parent company of the subcontractor, may be willing to provide a guarantee of performance. In addition, the subcontractor may agree to allow the contractor to withhold an increased level of retainage from monthly progress payments. Note that with each of these alternatives, however, there comes increased risk to the contractor.

The contractor’s decision to require subcontractor performance and payment bonds may need to be made on a case-by-case basis, weighing the advantages and disadvantages and considering any requirements of the contractor’s own surety. The contractor’s decision, however, should not be taken lightly given that the failure to recognize, calculate and properly manage the risk inherent in any construction project can lead to financial disaster for any one or all of the participants in a construction project. For a related article, see Use Performance and Payment Bonds to Protect Against Downside Risk. Send me an email, and I will send you a copy.

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