CORPORATE EXPOSURE: Surety Bonds

Harry P. Mirijanian

Insureds often misunderstand the protection that surety bonds provide during construction and rehabilitation projects. We can all identify construction projects within our own company—or even during our daily commute—where these bonds could be employed. The combined effects of rising population (which results in greater public demand) and weakening infrastructure mean that construction should remain active for years to come. Business reports, in fact, indicate that more contractors are entering the construction profession than at any time.

Any organization that retains contractors and develops fixed pricing contracts should consider a bonding program an intricate element of its risk control management efforts. What are the benefits or levels of protection you get when you incorporate bonding into your project?

The Basics

To begin with, what the surety company is offering when it issues a bond is its assurance that it will satisfy the contractor's obligations if a contractor fails to do so.

It is necessary to have a basic understanding of the three typical bonds that exist. The "bid bond" offers sleep insurance that the contractor will sign the contract to perform the work at the price quoted. It is not a guarantee but an assurance that the bid was developed with all reasonable care and due diligence. The "performance bond" protects the owner against financial loss should the construction firm renege on the contract terms. The "payment bond" protects the owner should the contractor fail to pay material bills, laborers, or subcontractors needed to complete the job. Together, these three types of bonds offer the owner a considerable level of protection and should not be discarded.

There is another valuable protection that the bonding company offers when it issues a bond, however. Before the company exposes itself to any risks, it will perform an extensive review of the contractor's abilities, resources, work in progress schedules (to make sure they are not overextending themselves), and so on. Underwriters will review at minimum the contractor's past performance records, résumés of key personnel, supplier and sub-contractor relationships, contingency plans, and credit ratings. A review this comprehensive would be difficult for your company to complete.

Some organizations believe that a financial statement review is all that is required before selecting a contractor. But reviewing a contractor's financial statement can be like hitting a moving target. An unforseen site condition can truly change a project from a profitable contract to a huge financial loss for the contractor. The strength of a contractor's financial statement is contingent upon its ability to complete its existing obligations. This being the case, the surety will demand a contractor's personal guarantee, supported by personal finance statements. Again, this is not necessary if you require a bond, since it is essentially being done for you by the surety company.

Adequate protection is particularly important

Another advantage to a bond is that it will assure the owner and the contractor that any contract disputes will be reviewed by an outside independent party for clarification and ruling. If only two parties are subject to a contract, numerous disputes can come up. By having a third party involved, such disagreements can be minimized or avoided completely.

Unwise Alternatives

These are only the minimum services a bonding company provides when it issues a bond. Let's look at the alternative to receiving a bond on a project.

The company owner can self-insure the risk by conducting an internal review of the contractor. This is ill advised. Some companies may require contractors to provide a letter of credit or establish some type of escrow account until the job is completed. Once again, this approach is not recommended; among other things, it requires extensive monitoring and compromising. Besides, if a contractor fails to perform, it is difficult to quantify the true financial loss that will be realized when the project is put out to new bids.

Further, project owners have been held responsible in failed construction jobs for having incomplete due diligence contractor reviews and, more specifically, for not requiring performance bonds.

Some insureds mistakenly believe that requiring only a bid bond is cost-effective, presuming that this is adequate to guarantee contractor performance. Obviously, this is not the case. We recall one contractor that was having difficulty securing a bond line. The bond company offered a program after the contractor posted a $1 million irrevocable letter of credit, with the bond company. However, the contractor could only offer a bid bond that did not exceed $200,000, and there could never be more than $1 million in the aggregate for all bid bonds released. Nonetheless, the contractor provided the bid bond and convinced project owners that performance bonds were not necessary. Although we do not believe that this particular contractor ever defaulted on a job, this illustrates an exposure if all three bonds are not posted.

The cost of bonds is usually a percentage of the contract value and will vary between one and six percent. Naturally, such factors as the complexity of the job, the contractor's past performance, and contract language will affect the premium. But the premium is a small expense when compared to the exposure.

Insurance brokers' experience with bonding lines will vary dramatically, with some having no construction knowledge. It is our opinion that organizations should deal exclusively with construction bonding experts. Without a solid relationship with the limited number of bonding organizations, as well as a working knowledge of the construction process, your organization will not be well serviced if you fail to deal with brokers that are conversant in this area.

Harry P. Mirijanian is president of Applied risk, an independent risk management services firm established to assist the business community in reducing exposure to loss and insurance costs. He is a frequent speaker at AMA seminars.

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