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Surety Bond Alernatives For The Construction Industry

Similar to banking, bonding is a form of credit. To that end, qualifying for bonding credit can be challenging if your financial house is not in order. Often times during the information gathering process, surety bond underwriters are asked if there are alternatives to bond requirements. There are however, seldom few of these alternative arrangements provide complete financial assurance to the parties involved. Below are several we typically see.

Joint Check Agreement

As stated, many subcontracts include a joint check provision. Typically, those provisions give the general contractor the unrestricted right to issue joint checks to the subcontractor and its suppliers. It is also common for a supplier to require that the general contractor to execute a stand alone joint check agreement before the supplier will extend credit to the subcontractor. There are generally two forms of such joint check agreements.

The first version will require that all payments to the subcontractor be in the form of a joint check. Such a version will also require the general contractor to guarantee that the supplier will be paid for all materials supplied to the subcontractor for the project in question. The second version is similar to the first version but does not include a guarantee or a requirement that all payments to the subcontractor be in the form of joint checks.

For example, a general contractor issued a joint check to its subcontractor and the subcontractors supplier. The subcontractor and the supplier had a "gentlemen's agreement" whereby the supplier would endorse the check, the subcontractor would deposit the check and subsequently pay the supplier. However, the subcontractor kept the funds. Subsequently, the supplier recorded a mechanic's lien and filed a lawsuit to foreclose the lien. The supplier lost the foreclosure suit. The supplier also set forth a cause of action that sought payment on the payment bond.

The Court recognized that use of joint checks was common in the industry. The Court went on to hold that (1) where the subcontractor and its supplier are joint payees and no agreement existed with the owner or general contractor as to any allocation of proceeds, the supplier by endorsing the check was deemed to have received the money due him, and (2) because the joint check was deemed payment to the supplier, the supplier could not recover on the owner's or contractor's surety bond. In essence it is the duty of the supplier to ascertain the intentions of the issuer of the check as to the allocation of the proceeds of the joint check. If the supplier fails to get written instructions from the issuer of the joint check prior to endorsing it, the supplier is deemed to receive all the check proceeds.

There are exceptions. One is when the owner designates the payment for specific merchandise. If the balance due for the merchandise is satisfied with a portion of the joint check the balance paid to the subcontractor is not applied to any other balance due the supplier.

In conclusion, joint checks only address the payment bond exposure. Joint checks do not guarantee the project will be completed on time according to the terms and conditions of the contract. The performance bond does that. Joint checks can be traps for the unwary.

If you are an owner or general contractor, issuing joint checks may be an effective method for ensuring that a supplier is paid. If you are a payee on a joint check you should ascertain if there is any existing agreement as to the allocation of the check proceeds. If there is such an agreement the allocation of the proceeds should be made in compliance with that agreement. If there is no agreement you may want to obtain such an agreement or instructions from the issuer of the check before you endorse the check. Under all circumstances if you issue joint checks or receive one as co-payee you should determine the intentions of the party who issued the joint check and comply with his wishes.

Subcontractor Default Insurance (SDI)

Subcontractor Default Insurance (SDI) is an insurance policy that provides coverage to general contractors for the direct and indirect costs of subcontractor defaults. Some general contractors use SDI in lieu of requiring bonds from subcontractors. Some general contractors use both SDI and bonds as risk shifting tools. With high deductibles and co-pay provisions, SDI is not “first dollar” coverage for subcontractor defaults. It is generally not sold to contractors with annual volumes of less than $50 million. It is a product best suited to large contractors with proven discipline in their careful selection and management of their subcontract risks.

Subcontractors may have mixed reactions to working on SDI project. On one hand, they are not required to use their available surety credit. That means that the owners of the subcontracting entity may not have personal liability as they would to their surety. It also means that scarce surety credit is available for other projects. On the other hand, they may find that the general contractor, sensitive to the amounts it is self-insuring, has imposed tighter controls on progress payments, requires personal guarantees, or asks for sensitive financial information that would not have to be provided in a bonded situation.

Suppliers to subcontractors may or may not find it easy to extend credit to subcontractors on SDI projects. SDI affords them no direct payment bond coverage. They are required to file liens against the project and project owner, or claims against the general contractor’s surety. Most subcontract payment bonds provide direct actions for suppliers and have less restrictive notice requirements than lien laws and statutory bonds. A supplier often has a claim against a subcontract bond when it has already missed the deadlines to file against the project or general contractor’s bond. On the other hand, suppliers may take comfort that the general contractors will be more rigorous in their monitoring of payments and securing of interim lien releases, or more inclined to pay lien or bond claims with SDI as a source of recovery.

Project owners may find no significant difference between a general contractor bonding its subs and using SDI. The cost to the project is about the same. A general contractor that bonds its subs may suggest that it has better prequalified subcontractors, higher coverage limits, and greater payment protection for suppliers and second tier subcontractors (which theoretically creates an opportunity for better pricing). Additionally, there is no deductible associated with a surety bond however, SDI coverage typically calls for deductibles of $500,000 or more.

SDI users often suggest that the absence of subcontract bonding requirements will mean that the SDI user has greater flexibility to employ the small and minority contractors who are so often the target of public owners' social goals.

In truth, both are excellent risk management tools in the hands of the sophisticated and usually well financed general contractors who use SDI.   Overtime, many general contractors have come to appreciate some of the unseen services of the surety industry…for example, the subcontractor that is financed and "propped up" by its surety behind the scenes. Between the administrative cost of prequalification and administration, and the begrudging appreciation for the difficulty of a surety's role in a subcontractor failure, it is our experience that many SDI users have gained a newfound respect for the surety product.

Joint Venture Agreements

This option makes sense when the general contractor is unable to qualify for surety credit. When a joint venture agreement is entered into with solvent party we see the party providing indemnity for the bond getting the lion's share of the profits. And rightly so! Depending on gross receipts by the indemnitor/joint venture owners entity this arrangement could preclude unbondable entity from qualifying under The U. S. Small Business Administration (SBA) program. Surety typically agrees to assume 30% of the bond exposure while transferring 70% to the SBA. In exchange, surety will handle claims should one arise. Although SBA programs have an additional SBA fee of 0.6% of the contract amount, the SBA program is useful when the unbondable entity wants to grow their business and ultimately not rely on joint venture arrangement and into stand alone bonding capacity. Sureties participating in the SBA programs can write bonds up to $1.25 million. To qualify for SBA assistance, a contractor's sales can be up to a $5 million average over three years, including all related entities.

Labor Only Contracts and Project Phasing

Occasionally, a subcontractor may not have enough surety capacity to provide a bond on an entire project. To reduce bond exposure, the surety will require Phase 1 completion prior to bond approval for Phase 2. The subcontractor may ask to have the general contractor to purchase the materials and equipment direct and execute labor-only contract in order to be in a position to provide a bond. This type of situation should be considered very carefully. Why is the surety unwilling to execute a larger bond? Are there other considerations that make this a risky proposition? The same thing is true of phased contracts. Receiving a bond on the first phase of a contract is no guarantee that a bond will be available on the second phase.

Surety Bond Waivers

Bond waivers hurt more than help especially in a weak economy. Legislative efforts could hurt more than help contractors and taxpayers. Because mechanics liens cannot be asserted against public property, laborers, subcontractors and suppliers on projects must rely on the general contractors payment bond for protection. If this bond is waived, these parties have no way to collect for their services and supplies if the contractor is unable or unwilling to pay them. Small and emerging contractors are more likely to begin as subcontractors. If no bonds are in place, subcontractors and suppliers either have to risk losses from nonpayment that they cannot afford, or not work on the public jobs for which they are qualified.

In the current economy, contractors must have payment protection. The performance bond ensures the project is completed with the state and local taxpayers paying only the contract price. If a performance bond is not provided, the taxpayers take on the risk that the contractor will default. If no bonds are in place (i.e. bonds waived) and a default occurs, the state and local contracting entities bear the burdon of re-letting work and paying any excess completion costs. Those costs ultimately are borne by taxpayers. Most state and local budgets currently have little or no leeway to absorb the extra completion costs from a contractor default.

Because waiving bond requirements permits contractors to bid on public projects without being required to provide payment and performance bonds, the result could be that financially unstable contractors – which otherwise cannot obtain bonding and are not prequalified by sureties – would be bidding and obtaining public construction projects. This increases the risk of nonpayment for subcontractors and the risk of default to the state and its taxpayers.

There is good public policy for the universal requirement of surety bonds on both public and private works projects. These bonds guarantee the project will be completed and that subcontractors, suppliers and laborers get paid. If a surety backs a contractor that defaults on the project, the full amount of the surety bond is available to complete the work and to pay the companies that performed work on the project.

It makes little sense in weak economy to waive the protections of the performance and payment bonds required by owners, lenders, state and federal law.