



The rise of the performance bond on a private project - Reevaluating whether it is a sound decision

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A performance bond is a three party agreement between a surety, contractor and owner, whereby the surety becomes obligated to complete and/or fund completion of a construction project if the contractor is unable to perform or otherwise defaults under the terms of the contract. Historically, the vast majority of performance bonds were issued in connection with public projects, due to a statutory mandate for projects over a minimum dollar threshold. Conversely, performance bonds were mostly absent from all but the largest private construction projects, as there exists no statutory requirement for their issuance.

Like everything else, though, the current down economic climate has caused private owners, regardless of project size, to reevaluate whether it is sound business judgment to engage in a construction project without first requiring contractors to secure a performance bond. Needless to say, the requirement that contractors secure a performance bond is a trend in private construction projects that does not appear to be waning. The reasoning is simple; contractors have been hit hard by the economic downturn and the contractor defaults are on the rise. Many contractor defaults arise because they do not have the resources available to complete projects if their cash flow is impacted by any one of a number of factors such as using revenue from one project to pay costs for another notwithstanding the fact that such action is against the law. In addition, contractors, in an effort to stay in business, have been submitting bids with little or no profit. In those instances, if the contractor encounters any problems on the project which increase its projected overhead or delay the completion of the work, the contractor will default due to the impact to its cash flow.

While there is no doubt that procuring a performance bond from the contractor gives the owner significant protection against losses from a contractor default, a private owner must be mindful that by requiring a contractor to secure a performance bond, that owner may also be curtailing the number of available contractors to bid on the project. There are a number of reasons why a contractor may choose not to bid on a project requiring a performance bond. A contractor may feel that the overall dollar value of the construction project is not worth the time and expense in securing a bond. Other contractors may not even try to secure a bond because they perceive their business as either too small or not yet established enough for a commercial surety to underwrite a performance bond on their behalf. Still other contractors may go through all the time and effort to apply for a performance bond, only to be rejected or withdraw because the bond premium is too high and the owner declines to pay the premium.

Much like how the economic downturn has caused commercial lenders to become more restrictive in their lending practices, the economic downturn has also caused commercial sureties to become more restrictive with their underwriting procedures and guidelines. Before issuing a performance bond, the surety's underwriters conduct a comprehensive evaluation of a contractor's financial

credentials and work history. Underwriters may also consider whether that contractor's proposed indemnitors have sufficient enough resources to collateralize the surety should a loss occur under the performance bond. Another consideration that cannot be overlooked is the surety's perception of the private owner and the scale of the project. While payment for public projects is secured, a surety may consider the risk that it may be called upon to defend against a performance bond claim made by an owner in breach of its payment obligations to the contractor.

Thus, while private owners are availing themselves of performance bonds with greater frequency than in the past, these very same owners may wish to consider whether requiring a performance bond will hamper their ability to get the contractor best suited for their project. However, given the tenuous nature of the construction industry in general, one can hardly blame a private owner for seeking the added assurance of a performance bond even at the expense of having a smaller pool of contractors by which to choose.

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