



Understanding the Differences between Performance and Payment Bonds and Project Completion Services Agreements

The National Association of Surety Bond Producers (NASBP) is a national trade association of agencies employing surety bond producers, including producers who place bid, performance, and payment bonds on private and public construction projects throughout the United States. In addition, the vast majority of the top 100 surety companies in the United States are affiliate members of the NASBP. Through its members and affiliates, NASBP has become aware that there is a growing trend for certain construction consultants to represent in the marketplace that project completion services agreements (PCSAs), also referred to as completion guarantee contracts, are an alternative to performance and payment bonds. This disturbing trend to market PCSAs as acceptable alternatives to performance and payment bonds is simply not supported by reality. In order to educate owners, lenders, and other industry stakeholders concerning why surety bonds provide superior protection to PCSAs, NASBP provides this white paper on what can be expected from performance and payment bonds and what can be expected from PCSAs.

The value of contract bonds (bid, performance, and payment bonds) for construction projects and their stakeholders, including owners and lenders, is to provide various protections and services. A performance bond guarantees completion of the project if the contractor defaults on its performance obligations. A payment bond guarantees that covered subcontractors, suppliers, and laborers on a project will be paid for their work or materials supplied. Before agreeing to issue such bonds, a surety undertakes a thorough underwriting process to prequalify a contractor for the particular project to be bonded. During this prequalification process, sureties review a contractor's qualifications and experience, current workload, current and past financial health, history of successfully completing projects, credit history, management capability, reputation, among other factors. Only a contractor determined by the surety under its underwriting criteria to be fully capable of performing its contract obligations is accorded surety credit. It is a thorough and confidential process centered on the contractor's on-going work program and focused on the crucial tenet of preventing incidences of contract default from the onset. Bonded contractors are further incentivized to complete contract obligations as sureties, believing their bonded contractors are capable of performing, require personal and corporate indemnities from those contracting firms in the event that the sureties have to pay out under the bonds.

Notwithstanding the sureties' extensive prequalification of contractors, sometimes the unexpected occurs; and the surety is called upon to assist a troubled contractor. Sureties are in a unique position to help avoid termination situations before they occur by providing "silent services" to a contractor. For instance, a surety might choose to finance a principal that is having financial difficulties, in order to ensure that it will meet its bonded obligations, thereby avoiding unnecessary disruptions to a project that would result from a termination.

In the event a termination does occur and it is necessary to have another contractor complete the contract, sureties have experience in facilitating the completion of projects of all sizes, requirements, and levels of complexity. Performance bonds protect the owner and lender by furnishing the owner/lender with first-dollar coverage for contract defaults. Payment bonds provide specific project parties, various downstream subcontractors and suppliers furnishing labor, materials and equipment, with a payment remedy in the event of their nonpayment. Contract bonds are a true risk transfer mechanism, from the owner or lender to a third party. On the other hand, PCSAs are not a true risk transfer mechanism; they are a services agreement, often providing solely administrative oversight for completion of a project.



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It is critical to understand that a project completion services agreement, in its varying forms, is simply not a viable alternative to the protections provided by performance and payment bonds and the prequalification services that precede the issuance of such bonds. And while the specifics of PCSAs differ, none provides the same protections as performance and payment bonds. An owner or lender that executes a PCSA in lieu of requiring performance and payment bonds has lost the valuable prequalification services of the surety. Often in such agreements the completion provider takes little real risk and provides very little protection to the owner or lender. Unlike performance and payment bonds, PCSAs usually exclude from their scopes any increased costs to complete, variances from the plans and specifications, and claims from subcontractors and suppliers. Thus, the owner or the lender is not protected from increased costs due to default or termination. In addition, unpaid subcontractors and suppliers that would otherwise be protected by payment bonds would be forced to file liens. With a payment bond in place, all claims are made to the surety; and the surety, in turn, performs an investigation and resolves the claims as appropriate. Most PCAs expressly disclaim any benefit to subcontractors, material suppliers, and laborers, leaving all risks of non-payment to the owner or lender.

Of course, PCSAs would never be appropriate on public works projects, as the federal Miller Act and Little Miller Acts in all 50 states, recognizing the value of such bonds, require bonding on all public works projects over a certain threshold amount. These bonds have assured the successful completion of public construction projects and protected businesses for many years.

Those construction consultants that market their project completion services often tout that their completion services cost the owner or lender less than the bond premium. Even if that were true, the benefits to the owner or lender of performance and payment bonds far outweigh those of PCSAs. It would indeed be “pennywise and pound foolish” to predicate such a decision solely on initial cost. Ultimately, performance and payment bonds give the owner or lender much better value than PCSAs.

As a final matter, owners or lenders that are considering use of a PCSA in lieu of performance and payment bonds should remember that surety or insurance companies that issue these bonds are highly regulated by insurance departments in the states where the companies do business. These state insurance departments have a number of requirements that the companies must meet, including specific financial requirements. Surety and insurance companies also receive financial strength ratings from rating agencies, such as A.M. Best Company and Moody’s. In other words, owners and lenders can determine readily the financial strength of a company that issues performance and payment bonds for their projects. There is no similar third-party rating system for those construction consultants that market their services as project completion providers. Therefore, while sureties are highly regulated and have well-regarded, third-party prequalifiers, owners and lenders do not have the benefit of any entity prequalifying the financial strength and experience of construction consultants offering completion services.

In short, the proposed services in a PCSA are not a proper substitute for the protections of performance and payment bonds. Generally, the services offered in a PCSA essentially amount to administrative oversight; while contract bonds protect the owner and lender from performance and payment risks associated with a contractor default.