



NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

7735 Old Georgetown Road, Suite 900

Bethesda, MD 20814

Tel: 240.200.1270

Fax: 240.200.1295

www.nasbp.org

IMPORTANT: Project Owners Beware!

Don't Eliminate Prime Bonds in favor of Dual Obligatee Status on Subcontract Bonds

Recently, some project owners report that general contractors (GCs) and construction managers at risk (CMs) try to convince them to do away with statutory and/or contractual requirements for these parties to furnish project owners with performance and payment bonds. These GCs and CMs argue that their prime bonds are not needed by project owners if GCs or CMs bond their subcontractors and provide project owners with dual obligee riders on these subcontract bonds. That argument, however, is not accurate, as project owners which accept that practice ***do not have equivalent protection***.

Prime bonds—those performance and payment bonds directly furnished by GCs and CMs to project owners—cover the entirety of the contract obligation being undertaken by the GCs or CMs. Further, the combined performance and payment bonds typically cover 200% of the amount of the contract obligation, as each of those bonds, issued by the same surety, usually is written for 100% of the contract amount. That is substantial, single-point protection if a GC or CM defaults in its performance. Statutory bond requirements, like the federal Miller Act and state “Little Miller Acts,” ***require performance and payment bonds at the prime contract level***, so that public project owners have full protection and subcontractors have payment protection.

It is important to note that failure to require prime bonds removes significant leverage the project owner otherwise would have over the GC or CM. GCs and CMs have “**skin in the game**” when furnishing bonds on projects, meaning that the personal and corporate indemnity agreements they must execute with the surety company in order to receive the performance and payment bond provides strong incentive for the bonded GC or CM to complete performance and ***not walk away from project problems***, as that bonded firm must reimburse its surety for all amounts the surety pays on its behalf. This is critical leverage that the project owner has to keep the focus of the GC and CM on its commitments and to ensure project progress. Of course, the surety stands ready to address the GC or CM’s responsibilities in the event of a default and may address problems communicated to the surety early to avoid a default in the first instance.

If the project owner does not receive prime bonds and only receives dual obligee status on the subcontract bonds between the GC or CM and subcontractors, ***the project owner has gaps in bond coverage, as the owner does not have bond coverage for losses arising from defaults of the GC or CM***. Rather, the project owner only has bond coverage for losses arising from subcontractor defaults. If subcontractor failures result from non-performance or breaches by the GC or CM, the owner may

have no subcontract bond recovery recourse (with litigation against the GC or CM as the sole avenue for recovery).

In the absence of prime bonds, total bond coverage also is limited to the respective bond amounts for each subcontract, which may or may not be the equivalent of the amount of the GC's or CM's contract (as, for example, the GC or CM may provide the value of general conditions items or self-perform a portion of the work). Even when the GC or CM furnishes bonds in partial amounts, such as for the value of the work it is self-performing, which typically is proportionately only a small percentage of the full contract value, the project owner does not have single-point coverage for the full value of the construction obligation, which, in public contexts, will not comply with statutory bonding requirements. Further, one defaulting subcontractor also may have consequential impacts on the work of other subcontractors, magnifying project problems, but bond recovery may be limited to just the bonds of the defaulting subcontractor, and the project owner is left to sort out a complicated project problem.

Where project problems arise from multiple defaulting subcontractors, the project owner now has the burden and the complexity of addressing claims to multiple sureties, rather than to the single surety writing the bonds of the GC or CM (which either were not furnished or furnished in inadequate amounts). Such a position of having to coordinate multiple claims processes is unnecessary when prime bonds are in place for the full contract value, thereby avoiding the considerable diversion of time, focus, and resources which the project owner would incur in such a situation.

Project owners also should note that the absence of the prime payment bond means that first-tier subcontractors have no bond payment protection. That absence may dissuade participation by first-tier subcontractors or likely will incentivize them to include additional contingencies in their subcontract prices, thereby increasing the overall project cost. Further, on private projects, non-payment by the GC or CM to first-tier subcontractors may lead to the placement of liens against the property. These consequences, of course, can be avoided by maintaining requirements for prime payment bonds.

The findings of a recent study undertaken by the accounting and consulting firm Ernst & Young validate and reinforce the economic benefits of requiring surety bonds for construction contracts. Prepared for The Surety & Fidelity Association of America, the study found that bonded projects—those requiring bonds at the prime level—had a lower rate or likelihood of default and that bond requirements improved or lowered contractor pricing. The study also found that unbonded projects which experienced a contractor default had significantly higher costs of completion than bonded projects. The study can be accessed at <https://surety.org/suretyprotects/>.

Arguments by GCs and CMs that their bonds are not needed if their subcontractors are bonded simply are inaccurate or **not the complete picture**, and decisions made on that basis will deprive the project owner of full performance and payment protect for the project. Savvy project owners should discern

the motives behind why the GC or CM is making those arguments, as the best interests of the project are served when full bond protection is in place!

NASBP encourages project owners with questions about surety bonding to consult with knowledgeable surety bond professionals and to read NASBP's publication "**Answers to 32 Questions Public and Private Owners Ask About Contract Bonding**" available at <https://www.nasbp.org/resource/answers-to-32-questions-public-and-private-owners-ask-about-contract-bonding/>.