



Why GCs Should Bond Back Subs

Bonding subcontractors protects the GC's investment in the project.



BY RICHARD SGHIATTI

THERE ARE MANY reasons why a surety company might suggest that a general contractor (GC) bond back its key subcontractors. In this article, we'll consider some of those reasons; but we'll also look at the objections general contractors make to bonding subs, how to respond to them, and why GCs still need to be fully bonded.

GCs sometimes view subcontractor bonds as an unnecessary expense that adds to the overall price of a job. It's not uncommon for GCs to insist that their subs do excellent work and are very reliable, so a bond isn't needed. "I've known Joe for years," a GC might say. "He always comes through. Why should I require him to get a bond? It makes me look like I don't trust him."

However, there are two very good arguments for why GCs should have at least their specialty and critical-path subs bonded.

First, there is the simple fact the GC's surety company may ask for subcontractor bonding as a condition of writing the GC's bond. Perhaps the GC wants to bid on a job that's much larger than its previous jobs or outside the scope of its usual work. Bonding key subs helps mitigate the risk and gives the GC's surety the confidence that the subs will, indeed, come through on their part of the job. It allows the GC's surety to be more flexible and consider bonding a project above the GC's normal bonding capacity.

Second, subcontractor bonding protects the GC's investment in the overall project. The GC is putting its capital at risk by taking on subs that could—if the job goes south—expose it to losses and jeopardize the entire project. A subcontractor bond gives the GC the peace of mind of knowing that a surety has checked the sub's financials, lines of credit, ownership changes, backlog, and experience. If the sub defaults, the GC has a means of recovering.

Bonding Subs Allows a GC to Take on Bigger Projects

Let's consider a GC that typically bids on jobs in the \$10 million range. It wants to bid on a \$40 million project, which, at first blush, seems beyond its surety capacity and unlikely to be bonded by its surety company.

But in looking at the project, the GC's surety sees that half the job (\$20 million) will be performed by two subcontractors. The surety knows that if these two subs are bonded, part of the risk will be shared with another surety company. After considering this and other factors—such as the experience and reputation of the subs, the GC's backlog, and the project manager assigned to the job—it decides to write the \$40 million bond.

With this example in mind, let's examine more closely what subcontractor bonds *do* and *don't do* for the GC.

- **Subcontractor bonds spread the risk, but the GC is still obligated to the owner.** In our example, the GC remains liable for completing the \$40 million job—regardless of whether the subs are bonded. In other words, the GC and its surety may be on the hook for the full amount of the project if it goes into default. Remember, the owner is

the obligee on the GC's bond, but the GC is the obligee on the sub's bond. Thus, if a bonded sub doesn't perform as expected, the GC may recover from the sub's surety. Bonding back subs transfers part of the risk on the project, but it doesn't alleviate the GC of its responsibility to the owner.

- **Subcontractor bonds cover additional costs associated with a sub's default.** GCs often fail to consider the cost of a delay, building material price increases, and additional labor expenses when a sub is terminated and a new one must be hired. It may cost significantly more than the original price to bring in a completion contractor to finish a job. There may be other expenses as well, such as attorney's fees. If the sub is bonded, these added costs may be the responsibility of the sub's surety—not the GC.
- **Subcontractor bonds protect the GC's equity.** Could your GC clients survive the disruption and financial exposure of a subcontractor default? General contractors work hard to build their businesses. Some have grown small, family-owned concerns into multi-million-dollar companies. Why would they want to put all that equity at risk? Yet that's exactly what they're doing if they don't bond back their subs. They're exposing their hard-earned capital with no guarantees in return.
- **Subcontractor bonds mitigate unforeseen risks.** A GC may view a sub as highly reputable and question the need for it to be bonded. But as the saying goes, "You don't know what you don't know." The GC doesn't know how many other jobs the sub has and whether the sub is overcommitted. The GC doesn't know if the sub is having financial difficulty, management issues, or a disagreement on another project that could shut it down. The GC can't predict if the sub's owner will suddenly get sick or die, and whether there's a succession plan. Bonding makes these unknown factors less risky.

Clarifying Bond Premium Amounts

GCs may complain that subcontractor bonds add to the cost of their bid since the subs will include the cost of the bond in their price—which, in turn, gets rolled

up into the GC's bid. Yes, a GC may be able to come in a little lower on its bid if it doesn't have to bond its subcontractors. But at what cost if there's a major problem with a sub? A subcontractor bond gives the GC financial security; and, frankly, at only 1%–3% of the value of a sub's job, it's money well spent. Don't let your clients be penny wise and pound foolish.

A GC may also question why it's paying the full premium for its bond when the subs are bonded, too. In our example, the GC's surety company can be liable for the full \$40 million if the project defaults. Consequently, the GC's premium reflects that \$40 million risk. The project owner will hold the GC and its surety responsible if the project doesn't meet the requirements of the contract. Therefore, the GC pays a premium based on the full project amount.

Which Subs Should Be Bonded?

As we've discussed, specialty and critical-path subs should always be considered for bonding. It's also a good idea to bond any subcontractor that can't easily be replaced or when there are only a few such contractors available to do the job.

In addition, subcontractors that install complex systems such as HVAC and smart building technology can pose a risk to the project if they fall behind or the system doesn't function properly. Requiring that these contractors be bonded can give the GC recourse.

A contractor that is unknown to the GC is another prime candidate for bonding. The GC's usual electrician may not be available for the job. A subcontractor bond can provide that extra security should things not work out with the new sub.

Finally, GCs may wish to set a minimum dollar threshold for subcontractor bonds. If a subcontractor's job exceeds a certain dollar amount, it would trigger a bonding requirement.

Bondability Letters vs. Bonds

Your clients may be tempted to ask for a bondability letter from a surety rather than have their subs secure a bond. Bondability letters serve a

purpose in that they provide documentation that a surety has evaluated a contractor's financials and would likely write a bond if requested. However, a letter can't guarantee a contractor's performance or ensure it will pay its bills.

Nor does requiring a bid bond guarantee a subcontractor's performance, since a bid bond simply commits the sub to entering into a contract for the amount bid. Only a performance and payment bond can transfer risk and provide recourse if the sub defaults.

How You Can Help Your Clients

Surety bond producers can add value to the client relationship by offering tools to help mitigate the risk of subcontracting. At the very least, you should make sure your GCs are prequalifying their subs in some fashion. Even just checking a credit reporting service like Dun & Bradstreet is better than doing nothing.

Bonding a subcontractor is the one sure way to guarantee the sub's performance. For a tiny percentage of the subcontractor's bid amount, the GC can transfer that risk to another party. It's a small price to pay for the successful outcome of the project and the continued profitability of the GC.

Find Out More

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Richard Sghiatti is Regional Vice President for Old Republic Surety's contract surety operations in the Southeast. He has been a speaker at Construction Financial Management Association and Associated General Contractors of America events and a contributor to industry publications on surety topics. He can be reached at rsghiatti@orsurety.com.

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MARTY MCCARTHY, CPA, CCIFP
MID-ATLANTIC CONSTRUCTION PRACTICE LEADER
610.943.4440
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