Hiring a commercial contractor? Don’t overlook risk

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By Nick Wright

Requiring performance and payment bonds is a cost effective way to protect your construction investment.
If you are growing a business, developing real estate or buying commercial construction services, you probably know “construction” equals “risk.” The safety of the tradespeople working on your property and the potential for physical damage resulting from construction activity all factor into your planning and risk management.

But one important and often overlooked risk is who you hire to do the work. Does the contractor you hired have the financial stability and relevant experience to build your project on time, on budget and to your specifications? Standard insurance policies do not cover these risks. The best and most cost effective way to protect your investment is to require the contractor you hire to provide performance and payment bonds.

What do performance and payment bonds do?

Performance and payment bonds guarantee the contractor will complete your project to the specifications outlined in the construction contract and will pay its subcontractors and material suppliers. If the contractor fails to fulfill its guarantees, a third party – the surety – steps in to finish the job and make sure the subcontractors and suppliers are paid appropriately, helping to keep your property free of mechanics liens.

For decades, federal, state and local government agencies have recognized the value and protection that surety bonds provide. Municipalities require bonds on the majority of public works projects in order to protect taxpayers.

Private buyers of construction services have increasingly followed suit. They realize that hiring an unqualified, financially unstable and unbonded contractor that may not complete the job on time (or at all) can have a devastating effect on their business. Delays could impair their ability to begin producing products and services from their newly constructed or reconstructed facility.

Why is a surety willing to take on this risk?

Construction companies have a disproportionately high failure rate among all businesses both in expanding economies and in recessionary periods. Sureties underwrite their customers thoroughly, examining the contracted company's financial wherewithal and work history as well as the character of the people who own and operate the company. This involves analyzing years of financial information and performance on individual projects. Often the underwriter also conducts face-to-face interviews with the contractor's management. The surety underwriter relates all of this information to the project you want to build. The underwriter will provide the bond only when he or she believes the contractor's credentials match the size and scope of your project.

This prequalification process serves as the backbone of the surety's ability to provide such broad guarantees. Contractors bonded by highly rated surety companies are probably working with professional surety agents, accountants and creditors that understand the construction industry. These are the hallmarks of the highest quality contractors and an excellent start to your investment in a successful construction project.

What kinds of private projects best benefit from a surety bond's protection?

The following are excellent examples of project and industry types that have the highest exposures and might be most negatively impacted by contractor failure. Ask your contractor to provide performance and payment bonds to financially secure their performance on your next construction project.

- Private schools and universities
- Hospitals and medical centers
- Financial institutions (and their commercial borrowers)
- Manufacturers
- Commercial and multifamily residential developers
- Corporate office owners and tenants
- Distribution and transportation centers
- Energy and power companies
- Religious institutions
- Recreation facility and amusement park operators
- Ports and marine interests
- Insurance services and agency expansions

When your business is considering new construction or expansion, make sure that the contractor you hire is bonded by a highly rated surety underwriter.

Coverages described here are in the most general terms and are subject to actual policy conditions and exclusions. For actual coverage wording, conditions and exclusions, refer to the policy or contact your independent agent.