CONSTRUCTION PAYMENT AND PERFORMANCE BONDS Myths and reality

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THE USE OF PAYMENT AND PERFORMANCE BONDS ON PRIVATE COMMERCIAL CONSTRUCTION PROJECTS IS WIDESPREAD BUT LARGELY MISUNDERSTOOD BY MOST REAL ESTATE PROFESSIONALS WHO COORDINATE CONSTRUCTION FOR THEIR CLIENTS AND EMPLOYEES.

Owners pay for these bonds; they are passed through on a contractor's bid, and whether the bonds are "required" is discretionary. In most instances, this decision depends in large part on two factors: (1) the size and "economics" of the deal; and (2) the owner's faith and confidence in the financial stability of the contractor.

Under most state laws, unpaid contractors, subcontractors and suppliers have the right to file mechanics' liens against the real property, placing the owner in default to the lender. There are many horror stories where owners have not required bonds and paid a contractor hundreds of thousands of dollars. The contractor abandons the project, files for bankruptcy and does not pay subcontractors/suppliers. Liens are then filed and, ultimately, the owner ends up paying *twice*. While "legally" the contractor should reimburse the owner, collecting money from the contractor is next to impossible if they have filed for bankruptcy or simply shut down the business.

Below are some common myths and realities associated with payment and performance bonds:

1. Myth: Obtaining both a payment and performance bond costs double.
Reality: It costs the same amount of money to obtain a payment bond as it does to obtain a performance bond.

2. Myth: Premiums are the same for every contractor.
Reality: Every surety has discounted/preferred rates for its most credit-worthy contractors, and premiums can vary wildly. Owners need to ask tough questions about the contractor's bond costs when bids are received.

3. Myth: Bonds are "guarantees" that a project will be completed on time, within budget and without any deficiencies. If anything goes wrong, the surety will respond in the gracious style of a "mythical insurance claim adjuster" who comes rushing to the scene of a disaster with payment in hand.
Reality: Bonds are *not* insurance. Frequently the surety is neither seen nor heard until the disaster has occurred. Forms have to be filled out, and if the owner fails to give timely and adequate notice, the surety will deny the claim on technical grounds. If a claim is disputed, the contractor will instruct the surety not to pay the claim or perform any additional work.

4. Myth: Bonds avoid/prevent mechanics' liens claims.
Reality: Bonds do not prevent the filing of mechanics' liens, but they do give a claimant another legal avenue for collection.

The decision as to whether a commercial developer/owner should ask for and require payment or performance bonds should be carefully examined. Certainly, if a contractor reports that he cannot obtain a bond, it is a good sign that he may not be financially viable. That, in and of itself, should raise serious concerns for any owner, especially on a large, complex project. ■