Understanding Construction Bond

An electronic handbook
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Table of Contents

Background 1
- Requirements for Construction Bonds 2
- Construction Bond Types 3
- Bid Bond 3
  - Bid Bonds vs. Performance Bonds 5
  - Failure to Meet Obligations 5
  - Bid Bond Liability 5
  - Frequently Asked Questions 5
- Performance Bond 6
  - Commodity Contracts 6
  - Advantages and Disadvantages of a Performance Bond 6
  - How to Get a Performance Bond 7
- Payment Bond 9

ACA Member Services 10

Background

What Is a Construction Bond?
A construction bond is a type of surety bond used by owners/investors in construction projects. Construction bonds are a type of surety bond that protects against disruptions or financial loss due to a contractor's failure to complete a project or failure to meet contract specifications. These bonds ensure a construction project's bills will get paid.

- A construction bond is a type of surety bond used by investors in construction projects.
- The bond protects against disruptions or financial loss due to a contractor's failure to complete a project or failure to meet project specifications.
- By submitting a construction bond, the party managing the construction work states they can complete the job according to the contractual policy.
- When a contractor fails to abide by any of the conditions of the contract, the surety and contractor are both held liable.
- The three main types of construction bonds are bid, performance, and payment.

How a Construction Bond Works
Construction bond, also known as a contractor license bond, is a required bond for a construction project. A contractor is required to have construction bonds for nearly all government and public works projects. A contractor vying for a construction job is generally required to put up a contract bond or construction bond.

The construction bond provides assurance to the project owner that the contractor will perform according to the terms stated in the agreement. Construction bonds may come in two parts on larger projects: One to protect against overall job incompletion, and the other to protect against nonpayment of materials from suppliers and labor from subcontractors.

There are generally three parties involved in a construction bond:

- The investor/project owners, also known as the obligee.
- The party or parties building the project.
- The surety company that backs the bond.

The project owner or investor is typically a government agency that lists a contractual job it wants to be done. To reduce the likelihood of a financial loss, the obligee requires all contractors to put up a bond. The contractor selected for

the job is usually the one with the lowest bid price since investors want to pay the lowest amount possible for any contract.

By submitting a construction bond, a principal—that is the party managing the construction work—is stating that they can complete the job according to the contractual policy. The principal provides financial and quality assurance to the obligee that not only does he have the financial means to manage the project but that the construction will be carried out to the highest quality specified. The contractor purchases a construction bond from a surety which runs extensive background and financial checks on a contractor before approving a bond.

Special Considerations
When a contractor fails to abide by any of the conditions of the contract, the surety and contractor are both held liable. The owner can make a claim against the construction bond to compensate it for any financial loss that ensues if the principal fails to deliver on the project as agreed or for costs due to damaged or defective work done by the principal. In cases where the contractor defaults or declares bankruptcy, the surety is held responsible for compensating the project owner for any financial loss. A surety that takes on the liability of a claim can sue the contractor for the amount paid to the owner if the terms of the construction bond permit it.

Requirements for Construction Bonds

Companies that get construction bonds generally follow these steps:

- Reviewing job requirements to see if a construction or contract bond is needed.
- Getting a bid bond from the surety agent and submitting it with the proposal.
- If awarded a contract, approaching the agent for a performance bond.
- Completing the job.
- Getting a maintenance bond, if required, once the job is completed to do any repairs.

Most government jobs require the use of a construction bond. However, there are some lines of work that don't qualify for construction bonds from American companies even when the job may be posted by the government. Any projects that take place overseas or on Indian reserves, projects involving private home remodeling, or even multi-year construction projects will not receive construction bonds.

Many U.S.-based surety companies may consider these projects too risky to insure. Laws, rules, and regulations may differ internationally or on native reservations, leaving the surety company in a rut if the contractor either doesn't

complete the job or violates the terms of the contract. And contractors may not qualify to do the work cited after a certain period of time, which makes it difficult to bond a longer-term project.

Construction Bond Types

A surety bond is the financial guarantor of a construction bond, guaranteeing the obligee that the contractor will act in accordance with the terms established by the bond. Surety companies will evaluate the financial merits of the principal builder and charge a premium according to their calculated likelihood that an adverse event will occur.

A surety can assist a contractor in having cash flow problems and may also replace a contractor who abandons a project. There are three main types of construction bond provided by a surety:

Bid Bond

A bid bond is necessary for the competitive process bidding. Each contending contractor has to submit a bid bond along with their bids to protect the project owner in the event a contractor backs out of the contract after winning the bid or fails to provide a performance bid, which is required to start working on the project.

A bid bond guarantees compensation to the bond owner if the bidder fails to begin a project. Bid bonds are often used for construction jobs or other projects with similar bid-based selection processes.

The function of the bid bond is to provide a guarantee to the project owner that the bidder will complete the work if selected. The existence of a bid bond gives the owner assurance that the bidder has the financial means to accept the job for the price quoted in the bid.

Bid bonds ensure that contractors can comply with bid contracts and will fulfill their job responsibilities at agreed prices. Most public construction contracts require contractors or subcontractors to secure their bids by providing bonds that serve as a means of legal and financial protection to the client.

Without bid bonds, project owners would have no way of guaranteeing that the bidder they select for a project would be able to complete the job properly. For example, an underfunded bidder might run into cash flow problems along the way. Bid bonds also help clients avoid frivolous bids, which saves time when analyzing and choosing contractors.

Requirements for Bid Bonds

While most project owners typically require between 5% and 10% of the tender price upfront as a penalty sum, federally funded projects require 20% of the bid. The cost of the bond depends on several factors, including the jurisdiction of the project work, bid amount, and contractual terms.

For example, a contractor that is making a $250,000 bid to provide roofing for an elementary school will have to submit a bid bond of $50,000. This bid bond is required along with a proposal to be taken seriously as a contender for a federal contract.

Writing a Bid Bond

A bid bond can be a written guarantee made out by a third-party guarantor and submitted to a client or project owner. The bid bond affirms that the contractor has the required funds necessary to carry out the project.

Typically, bid bonds are submitted as a cash deposit by contractors for a tendered bid. A contractor purchases a bid bond from a surety, which carries out extensive financial and background checks on a contractor before approving the bond.

Several factors determine whether a contractor will be issued a bid bond. They include the company's credit history and the number of years of experience in the field. Financial statements may also be examined to determine the overall financial health of the company.

Parties Involved

A surety bond involves three primary players: the financial guarantor or surety of a construction bond, guaranteeing the obligee that the contractor (called the principal) will act in accordance with the terms established by the bond.

- The obligee is the owner of the project who hires the contractor and requests the bond. This person or other entity sets the terms and conditions of the bond, and will file a claim if the contractor fails to perform or violates the contract.
- The principal is the contractor purchasing the bond. If the contractor fails to perform they will be liable based on the terms and conditions set forth in the contract and bond.
- Surety companies will evaluate the financial merits of the principal builder and charge a premium according to their calculated likelihood that an adverse event will occur.

Bid Bonds vs. Performance Bonds

A bid bond is replaced by a performance bond when a bid is accepted and the contractor proceeds to work on the project.

A performance bond protects a client from a contractor's failure to perform according to the contractual terms. If the work done by a contractor is poor or defective, a project owner can make a claim against the performance bond. The bond provides compensation for the cost of redoing or correcting the job.

Failure to Meet Obligations

If the contractor does not meet the obligations of the bid bond, the contractor and the surety are held jointly and severally liable for the bond. A client will usually opt for the lowest bidder since it will mean reduced costs for the company.

If a contractor wins the bid but decides not to execute the contract for one reason or another, the client will be forced to award the second-lowest bidder the contract and pay more. In this instance, the project owner can make a claim against the full or partial amount of the bid bond. A bid bond is thus an indemnity bond that protects a client if a winning bidder fails to execute the contract or provide the required performance bonds.

Bid Bond Liability

The amount claimed against a bid bond typically covers the difference between the lowest bid and the next lowest bid. This difference will be paid by the bonding company or surety, which may sue the contractor to recover the costs. Whether the surety can sue the contractor depends on the terms of the bid bond.

Frequently Asked Questions

What is a contract bid?
A contract bid is most commonly associated with a proposal and price submitted by a contractor or service provider to a soliciting firm for a business opportunity involving construction or renovation projects.

Can you get a bid bond with poor credit?
While having good credit is always helpful in matters like these, those with poor credit may still be able to obtain bid bonds from companies that agree to do so, but these will often be more costly to obtain.

Are bid bonds returned?
Once a project is successfully completed per the contract, the bid bond amount is returned.

What are the 3 major types of construction bond?
The three main types of construction bonds are bid, performance, and payment.

Performance Bond

A bid bond is replaced by a performance bond when a contractor accepts a bid and proceeds to work on the project. The performance bond protects the owner from financial loss if the contractor's work is subpar, defective, and not in accordance with the terms and conditions laid out in the agreed contract.

Performance bonds are provided to protect parties from concerns such as contractors being insolvent before finishing the contract. When this happens, the compensation provided for the party that issued the performance bond may be able to overcome financial difficulties and other damages caused by the insolvency of the contractor.

A payment bond and a performance bond work hand in hand. A payment bond guarantees a party pays all entities, such as subcontractors, suppliers, and laborers, involved in a particular project when the project is completed. A performance bond ensures the completion of a project. Setting these two together provides the proper incentives for laborers to provide a quality finish for the client.

Commodity Contracts

Performance bonds are also used in commodity contracts, where a seller is asked to provide a bond to reassure the buyer that if the commodity being sold is not in fact delivered, the buyer will at least receive compensation for lost costs.

The issuance of a performance bond protects a party from monetary losses due to failed or incomplete projects. For example, a client issues a contractor a performance bond. If the contractor is not able to follow the agreed specifications in constructing the building, the client is given monetary compensation for the losses and damages the contractor may have caused.

Advantages and Disadvantages of a Performance Bond

Performance bonds protect the contracting party in the event that their contractor may become insolvent or otherwise unable to meet the terms of a contract. If the costs of completing the project overrun their projections, the obligee will not be responsible for the additional expenses. This reduces the risk for developers or other companies when they engage in large-scale construction projects.

However, there are some risks to consider. The surety may attempt to argue that the obligee did not comply with all the requirements of the bond in order to deny payment. Or, they may try to get the obligee to settle on a lesser amount.

Moreover, it is up to the obligee to calculate the financial cost of a failure by the contractor. If the obligee underestimates the cost of non-performance, they will have to absorb those extra costs on their own.

Pros and Cons of a Performance Bond

Pros

- Protects an obligee from additional costs if work is not completed.
- Reduces the risk for developers in construction and other large projects.

Cons

- Bond issuers may attempt to deny payment.
- If the obligee underestimates the cost of non-performance, they will have to absorb these extra costs on their own.
- Performance bonds add an additional cost to the contractor that may be passed on to the obligee.

How to Get a Performance Bond

In order to get a performance bond, contractors need to apply to a surety for a letter of bondability. This non-binding letter states the monetary limits that the surety would be willing to provide to bond the contractor, based on factors like the contractor's experience and creditworthiness, and the size of the proposed project(s).

The bondability letter also confirms that the surety is registered and licensed in the state where the work will be performed, and provides contact information. Although this letter is not legally binding, it is a useful way of demonstrating a contractor's qualifications before they have to spend any money.

In order to become fully bonded, the contractor must provide certain financial information to the surety in order to underwrite the bond. This will depend on the amount being bonded: Smaller projects might require only good credit and a clean license history, while larger projects may require financial statements, balance sheets, and several years of tax returns. The contractor will also pay the company to provide surety, usually a small percentage of the bond amount.

Example of a Performance Bond

Suppose a hypothetical developer is looking for a contractor to construct a new apartment building. Because of the size of the project, they will require their contractor to be bonded. This provides the developer with protection if the contractor fails to meet the requirements of their contract.

The contractor will engage with a bond provider, or surety, to provide a performance bond for that project. In order to get a performance bond, the contractor agrees to pay the surety a small percentage of the total bond amount, usually between 1% and 4%. In exchange, the surety promises to pay up to the agreed bond amount if the contractor fails to deliver on its obligations.

If the contractor does fail to deliver, the developer can file a claim with the surety for damages equal to their losses, up to the value of the performance bond. The surety then investigates to determine the extent of the losses.

Industries That Use Performance Bonds

Usually, performance bonds are provided in the real estate industry. These bonds are heavily used in real property construction and development. They protect real property owners and investors from low-quality work that may be caused by unfortunate events, such as bankruptcy or insolvency of the contractor.

Performance bonds are also useful in other industries. The buyer of a commodity may ask a seller to provide a performance bond. This protects the buyer from any risk that the seller is unable to deliver the commodity, for any kind of reason. If the commodity is not delivered, the buyer receives compensation for losses and damages caused by the non-completion of the transaction.

How Much Does a Performance Bond Cost?

The cost of a performance bond depends on a variety of factors, such as the size of the project, the creditworthiness of the contractor, their license history, and the overall financial strength of the bonding party. In general, the rate usually ranges between 1.5% and 3.5% of the total value of the performance bond.

How Long Does a Performance Bond Last?

The time limit for claiming a performance bond will be spelled out in the bond contract. However, most performance bonds have a duration of twelve months, with some lasting for 36 months. In addition, your bond may be renewable or non-renewable.

The Bottom Line

Performance bonds are used to ensure satisfactory completion of contracted work. If a contractor is unable to deliver on their obligations, a performance bond allows the paying party to cover any additional costs due to their failure to deliver. These bonds are usually used for large construction or government projects that might take a long time to complete.

Payment Bond

A payment bond is similar to a performance bond, but it is used to guarantee payment to the contractors and subcontractors in the event that the principal becomes insolvent or otherwise unable to pay.

This bond is also called a labor and material payment bond, which is a guarantee that the winning contractor has the financial means to compensate their workers, subcontractors, and suppliers of materials. For example, a construction payment bond may need to cover the entire construction contract amount for a $5 million project, but a $50 million project only requires a bond of 50% of the total contract value. The required bond amounts are set out in the specific statutes of the state in which the project takes place.

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