PERFORMANCE BONDS

IN CONSTRUCTION & DEVELOPMENT

INFORMATION FOR EMPLOYERS & THE DESIGN TEAM

INTRODUCTION

To varying degrees, every construction project is marked by some uncertainty.

From the outcome of a tender competition to the many twists and turns of a construction project uncertainty is a factor. The nature of the industry is such that predicting the future with any great accuracy is always difficult - even during the good times.

When an economic downturn follows a boom - as it inevitably does, it has often been observed that the construction industry suffers first, suffers most and suffers longest. Uncertainty - *simply not knowing* - plays a part in this.

Advances in design and specification, new construction techniques, intelligent management methods and increased contractual awareness can alleviate the effects of uncertainty but a centuries old mechanism can directly and quantifiably remove a large element of the risk from any construction project.

A Contract Bond can offset a large amount of the uncertainty inherent in a construction project.

This booklet will outline why Contract Bonds offer exceptional value risk transfer for Employers and answer many frequently asked questions.

BONDS IN CONTEXT

As utilised in construction, a Performance Bond is a "contract of guarantee" whereby one party (the Guarantor) undertakes to pay damages to a second party (the Employer) arising from breach of contract by a third party (the Contractor).

The damages payable would comprise the *additional expense* incurred by the Employer as a result of the Contractor defaulting on its contractual obligations.

The most obvious, and usually the largest additional expense is the extra payment required to secure a new Contractor to complete the unfinished project.

Other additional expenses can include additional design team fees, security, insurance, sub-contractors and so on.

PROCURING BONDS IN PRACTICE

A Bond is a discretionary item in any contract. It is a matter for each individual Client to decide whether a bond is required from a contractor. This decision is usually made pre-tender and all tenderers would be made aware of the requirement.

Once the contract is awarded the contractor must arrange for a bond to be put in place. At this point the contractor should approach a reputable Bond Provider.

The contractor will need to satisfy the guarantor that it has the financial and technical resources and management capability to carry out and complete the contract in question. There is no magic formula – the guarantor relies on experience and intuition combined with an intimate knowledge of the contractor's business.

The ease or difficulty with which a contractor can procure a bond depends on many factors but the key factor is the contractor's relationship with the guarantor. Thus a contractor who has never had to arrange a bond will find it takes a little longer than one who has a long standing relationship with a guarantor.

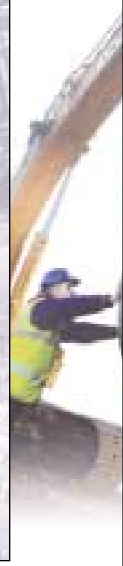
That being said, professional guarantors are in business to do business and we at Construction Guarantee pride ourselves on the speed of our decision-making and can usually confirm the availability of a bond within a matter days of all the relevant information being submitted to us.

It is important that Clients realise, however, that procuring a bond is not as simple as buying an insurance policy.

WHAT HAPPENS IF SOMETHING GOES WRONG? - A WORKED EXAMPLE

In this example, the original contractor has defaulted and been removed from the contract having completed €500,000 of a €1 million project.

	€	€
Original Contract Sum		1000000
Certified at date of default	400000	
Estimate of uncertified work	60000	
Retention	40000	500000
Work remaining per original contract		**500000**
New Contractor's Price to complete		600000
Cost Overrun		100000
Additional Fees etc		10000
Loss payable under Bond		**110000**



BONDS PROTECT YOUR BUDGET

The purpose of a bond is to protect the original project budget and thereby remove some of the uncertainty from the venture.

One of the most disruptive events that can befall any construction project is contractor failure.

Bonds provide the assurance that if your contractor defaults you won't incur extra cost.

This can be an important deciding factor when seeking funding for the project from financial institutions.

Any instrument that reduces negative variables must be embraced by all prudent Employers.

RISK TRANSFER

Bonds are all about Risk Transfer.

For an Employer, the alternative to requiring a bond is more risk in an already risky undertaking.

SOME QUESTIONS

The majority of construction projects run smoothly but...

- Can you, as Employer or Design Team Member say with 100% confidence that any given contractor will not default? Are you prepared to gamble up to 25% of the contract sum on that presumption?
- Do you know enough about the contractors business to take a chance?
- Can you predict what other projects the contractor will embark upon after commencing yours and how this will affect the performance of yours?

The solution is clear - require that your main contractor and all nominated sub-contractors produce bonds in your favour before signing any contract.

This one decision will remove a substantial risk from your project.

CONTRACTORS HAVE NOTHING TO FEAR

Professionally run, well-organised construction firms who have quality human resources and sound fundamentals have nothing to fear from a policy of requiring bonds.

A construction industry with a "Bond Culture" is a stable one with no place for ***Fly-By-Nightly Construction Limited***.

Producing a bond makes a strong statement about a contractor's organisation and its position in the construction industry.

It demonstrates sound management, financial stability and a professional attitude.

INSURANCE BONDS OR BANK BONDS?

The argument in favour of bonds is clear but the source of the bond should also be considered.

Banks and insurance companies are the only sources of bonds but historically they view the product in entirely differing ways.

Most Insurance companies underwrite bonds to a zero-loss ratio. This essentially means trying only to bet on "sure things" - in theory!.

Banks often look on bonds as extension of further credit facilities and therein lies a potential problem. In assessing a bond application, banks apply a similar process to assessing a loan application. If a bank issues the bond - the contractor's ability to raise further finance may be diminished. This can adversely affect cash-flow, which could lead to difficulties in the performance of contracts and possible default.

Thus, in procuring a bond from a bank the contractor may be causing exactly the outcome the bond was required to protect against!

THE MESSAGE IS SIMPLE -

Performance
Bonds make
commercial
sense

ADDRESSING SOME MYTHS

Myth: ***Requiring bonds will delay the start of the project***

Fact: A contractor with a track record with a bonding company should have no difficulty procuring a bond in a timely manner. Where no track record exists, the well-managed contractor should still be able to obtain the bond quickly from a specialist Bond Provider with the experience to rapidly assess any application.

Construction Guarantee is such a specialist Bond Provider - 18 years of issuing just bonds and only for the Irish Construction Industry.

Myth: ***Bonds are too costly***

Fact: A bond covering the beneficiary for up to 25% of the contract value costs less than 1% of the contract value.

Construction Guarantee recommends that such a cost effective risk management tool should never be omitted.

Myth: ***Bonds are only appropriate in recessions***

Fact: Even in times of plenty contractors can get into difficulties. Too much available work can lead to over-trading. Boom times can mean a scarcity of human resources. Construction is not an industry immune from over-heating.

Construction Guarantee feels that Bonds are appropriate in any economic climate. Reasons for default may vary but the risk is always there.

Myth: ***Small projects don't need to be bonded***

Fact: Regardless of the size of the project, difficulties can occur. In fact, smaller contracts are often relatively much more costly to complete.

Construction Guarantee advise that all projects be bonded, irrespective of size – the same fundamental principles apply.

Bonding is Simple

- If in doubt ask the Experts

ABOUT CONSTRUCTION GUARANTEE

Construction Guarantee was formed in 1984 to provide an alternative source of bonding for small to medium sized building contractors and sub-contractors.

Construction Guarantee has grown to become the largest specialist providers of bonds to the Irish market by maintaining this focus and providing a highly efficient service to our clients

Creative and flexible, our approach is personal and un-bureaucratic.

Contractors finding it difficult to procure a bond have found us to be open-minded, willing to listen and often able to assist where larger institutions have proven uninterested.

Our modern, plain-English bonds have been praised for their clarity and ease of understanding.

Clients and Design Teams regularly recommend us to their contractors

In association with Hiscox Insurance Company Limited, a leading UK specialist Insurer, we offer market leading expertise to over 700 Contractors and Sub-Contractors in all areas of the Irish Construction Industry.

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