Why Bid, Performance & Payment Bonds Are Required For Public Construction Projects

Virtually all of the public construction work in America is accomplished by private sector firms. This work generally is awarded to the lowest responsive bidder through the open competitive sealed bid system. Surety bonds play a critical role in making the system work.

The Bid Bond is intended to keep frivolous bidders out of the bidding process by assuring that the successful bidder will enter into the contract and provide the required performance and payment bonds. If the lowest bidder fails to honor these commitments, the owner is protected, up to the amount of the bid bond, usually for the difference between the low bid and the next higher responsive bid.

The Performance Bond secures the contractor's promise to perform the contract in accordance with its terms and conditions, at the agreed upon price, and within the time allowed.

The Payment Bond protects certain laborers, material suppliers and subcontractors against nonpayment. Since mechanic's liens cannot be placed against public property, the payment bond may be the only protection these claimants have if they are not paid for the goods and services they provide to the project.

Protection By Law

In most cases, bid, performance and payment bonds are required by law on public construction projects. Since these laws have existed for several decades, few give much thought as to why such laws were enacted. Some contractors who cannot obtain the required bonds, complain that the laws are unfair because they, in effect, are denied access to public construction projects. Let's examine what gave rise to these laws that require contractors to post bonds when they perform public construction projects.

Slightly more than 100 years ago, the federal government became alarmed about the high failure rate among the private firms it was using to perform public construction projects. It discovered that the private contractor often was insolvent when the job was awarded, or became insolvent before the project was finished. Accordingly, the government was frequently left with unfinished projects, and the taxpayers were forced to cover the additional costs arising from the contractor's default.

Since government property is not subject to mechanic's liens, the laborers, material suppliers and subcontractors were without remedy if they were not paid for their services. To protect itself and those who worked on its projects, the government tried using individuals to serve as sureties. However, many of these individual sureties failed to honor their commitments, often because they did not have the financial resources to cover their obligations. So, in 1894, Congress passed the Heard Act to authorize the use of corporate surety bonds to secure privately performed federal construction contracts. In 1935, the Heard Act was replaced by the Miller Act, which is the current law requiring performance and payment bonds on federal construction projects.

It is important to note that bid, performance, and payment bonds are not intended to protect the contractors that have to post them. Instead, these bonds are intended to protect the owner of the construction project against contractor failure and to protect certain laborers, material suppliers, and subcontractors against nonpayment.

Assuming The Risk

There are only two alternative methods of performing public construction. The government may perform the contract with its own forces or retain a private contractor to perform the construction contract.

If the government uses private contractors, which ones should be chosen? Those who are solvent or those who are insolvent? Those who have the technical ability to perform the contract or those who don't? Those who will finish the contract on time and at the agreed upon price or those who won't? Those who will comply with the plans and specifications or those who will cheat? Those who follow safety procedures and operate a safe job site or those who cut corners?

The answers should be obvious. However, all contractors when seeking work will say that they are solvent, honorable, and qualified to perform the project. Of course, some may be stretching the truth.

Thus, the construction project owner would be foolish to hire any contractor that happens to walk in the door. Some prequalification screening of contractors obviously is necessary. The government elected to use the surety mechanism, so the surety assumes the prequalification responsibility and protects the government against loss when a bonded contractor defaults.

Why The System Works

Even though the taxpayers, laborers, material suppliers and subcontractors would be left without protection if there were no bonds, some people suggest that government employees should prequalify the contractors that perform government construction projects. For a number of reasons, contractor prequalification by government employees is an unattractive alternative.

For instance:

- Every contractor is unique and every construction project is different. Thus, it is impossible to use purely objective standards in making sound contractor prequalification decisions. A subjective decision made by government employees is difficult for the government to defend if it is challenged by a disappointed applicant.

  When the private surety industry is used as the prequalifier of the contractor applicant, this problem is eliminated for the government.

- Contractors that are rejected by a government official have no place to go in search of a different result except to court. Lawsuits are expensive and time-consuming. Of course, if the suit succeeds, the government is now forced to use a contractor it wanted to avoid.

  When a contractor is turned down by a surety, the contractor may seek a different result from a competitor.

- When a government prequalifier makes a mistake in judgment, the taxpayer pays for the loss, not the government official who made the bad decision.

  When the surety makes a mistake in judgment, it pays. This forces the surety to make prudent prequalification decisions, thus the government and the taxpayers are protected.

- Whenever government officials are responsible for deciding which private contractors will be allowed to perform public contracts, it is virtually impossible to prevent contractors from using political influence to obtain a favorable prequalification decision.

  When private sector sureties are used, the potential for such corrupt activity is practically eliminated.

- Contractors may be reluctant to divulge business information to a government prequalifier who is, in effect, a representative of the potential owner of the construction project.

  With private sector sureties, contractors are submitting their applications and business information to a third party, the surety, and not the party they will be contracting.

Summary

The use of corporate surety bonds makes it possible for the government to use private contractors for public construction projects under a competitive sealed bid, open competition system where the work is awarded to the lowest responsive bidder. Political influence is not a factor, the government is protected against financial loss if the contractor defaults, and certain laborers, material suppliers and subcontractors have a remedy if they are not paid, all without consequence to the taxpayer.