Finance New Mexico

Article 233 March 19, 2012

Bonds Benefit Both Parties to a Contract, Not Just the Client

By Kendra Zacharias-Trujillo, Corporate Administrator, Rio Grande Insurance Services, Inc.

Many contractors — especially those with a demonstrated reliability and good credit — resent that they're required to be bonded for the work they do and consider bonds an unnecessary expense for something that doesn't appear to provide a tangible benefit.

But bonds protect the interests of both parties to a contract: They're a form of credit that helps the contractor attract serious, big-ticket clients, and they assure the client that he will receive money to cover the costs of finishing a project that isn't completed to contract terms.

A bond is a promise made by the bonding company to pay one party if the second party fails to meet an obligation. In that sense, it's a form of insurance. If a contractor defaults or a client presents a valid claim, the bonding company pays cash to the limit of guarantee — the bond amount — and the contractor must then pay back — or indemnify — the bond amount to the bonding company.

The type of bond that's needed depends on the scope of work involved. Contract bonds common in the construction industry guarantee the project's owner that a general contractor will fulfill a contract completely. Other construction-industry bonds include bid bonds (a contractor will enter into a contract if awarded the bid), performance bonds (the work will be done as specified by contract); payment bonds (a contractor will pay for services and materials) and maintenance bonds (a contractor will repair and maintain a facility for a specified time). Contractor license bonds are issued to artisan contractors, such as electricians, carpenters, masons and other tradesmen.

Some federal, state or municipal governments require license and permit bonds before issuing a license or permit to certain types of businesses. These bonds promise the government that a business owner will comply with underlying state laws, municipal ordinances or other regulations.

When dealing with bonds, contractors need to note the "penal sum"; this is the maximum amount that might be paid if there's a default. The penal sum is what the bonding company uses to assess the risk involved in extending the bond and to decide how much of a premium to charge the contractor to secure the bond.

Premiums are also based on a contractor's creditworthiness and net worth. Anyone required to obtain a bond can lower his cost by maintaining good credit, completing the terms of any bond so default is avoided and generally having a good reputation within his industry. The cost of the bond is determined by how much risk the bonding company feels it will assume if it has to pay out and can't collect from the contractor who defaulted; this is no small consideration, as many contractors went out of business during the recession and some couldn't complete the jobs they were working on.

As much as contractors and other business owners dislike forking over money for a bond, it's part of the cost of doing business in any given industry.

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