



Report to: GENERAL COMMITTEE

Date of Meeting: June 19, 2006

SUBJECT: The Merits of Bonds and Other Forms of Security
PREPARED BY: Catherine M. Conrad, Town Solicitor
Kevin Newson, Manager of Purchasing

RECOMMENDATION:

That the report entitled "The Merits of Bonds and Other Forms of Security" be received for information; and

That Council resolve to continue to require contractors hired by the Town of Markham to complete projects to produce performance and labour and material bonds as a condition precedent to entering into the contract with the Town.

EXECUTIVE SUMMARY:

Not applicable.

FINANCIAL CONSIDERATIONS:

Not applicable.

PURPOSE:

This report examines bonds and other forms of security and assesses their relative merits in connection with the Town's contractual and financial obligations in respect of contracts for capital projects such as building and park construction contracts.

BACKGROUND:

At the Council meeting on May 9, 2006, the issue of the utility of performance bonds when considering their cost and enforceability was raised. Staff were directed to report back with an analysis of the utility and efficacy of bonds and other forms of security, such as letters of credit, to ensure contractor performance and contract completion.

OPTIONS/ DISCUSSION:

The Town always has available to it the right to sue on a contract for poor performance or defective materials. Obtaining security from a contractor in relation to his contractual obligations is one method to ensure compliance without having to undertake expensive and time-consuming legal proceedings. This report examines two "third-party" forms of security, bonds and letters of credit, as well as a third option, self-insurance. Lastly, the report reviews the importance of good project management in using forms of security effectively.

What is a Bond?

A bond or surety is a written promise to pay money or do some act if certain circumstances occur or a certain time elapses. The bond is an agreement between a contractor (the "Principal") and a surety or insurance company (the "Surety") in favour of a beneficiary, the "Obligee" (the Town) in relation to a specific contract. A bond is

provided by a Surety on behalf of a contractor as a requirement of the contract with the Town. The bond references the agreement to which the bond relates and the total amount of the bond. The bond further stipulates the obligations of the Surety where the Principal is declared by the Town to be in default.

A performance bond is tied to the underlying contract. If the contractor fails to perform the contract, the surety has responsibilities to the Town and the contractor for project completion. A labour and material bond protects certain subcontractors, labourers and suppliers against nonpayment by the contractor which, in turn, offers to the Town some protection from liens.

The Surety may do several things under a bond. It may:

1. remedy the default;
2. complete the contract;
3. obtain bids for submission to the Town for a substitute contract; or
4. pay the Town the lesser of:
 - (i) the bond amount; or
 - (ii) the Town's proposed cost of completion less the balance of the contract price.

The Decision to Bond

The decision to provide a bond is made by the Surety. Sureties review the bond applicant's organization, assets and personnel to evaluate its ability to perform the contract for which the bond is sought to assess the risks of bonding. The Surety examines the capacity of the bond applicant to undertake and complete the project in relation to all of the applicant's other projects. The Surety also monitors a contractor once bonded and while a project is ongoing which may impact on the Surety's decision to maintain, increase, reduce or withdraw future support.

The Cost of a Bond

There are different rates of bonding, but the cost of a typical bond is \$6.00 per \$1,000.00 of the contract value. This cost is included in the bidder's quotation and is passed on to the Town by the bidder.

The Advantages of a Bond

Some of the advantages of a bond are:

1. the bond offers financial security to the Town upon the default including insolvency, bankruptcy, etc. of the contractor;
2. the resources of the Surety may be used to exert pressure on a delinquent contractor to perform during the life of the contract;

3. the "bondability" of a contractor assures the Town that the contractor enjoys a certain standard of financial and organizational well-being. It offers a financial method of prequalification;
4. the issuance of a bond has no effect on the contractor's bank line of credit and, in some instances, can be viewed as credit enhancement;
5. a labour and material bond may encourage subcontractors of suppliers to provide services and materials; and
6. the inability of a contractor to obtain a bond constitutes a clear ground for disqualification of a bidder in the procurement process.

The Disadvantages of a Bond

Some of the disadvantages of a bond are:

1. bonds are typically time-limited and project-specific and require that any action or proceeding on the bond be commenced within two (2) years following substantial completion of the default of the contractor;
2. the Town, as Obligee, is a beneficiary under the bond but is not a contractual party to the extent that it can force the Surety in every circumstance to take steps against the contractor; and
3. the cost of the bond may be significant on a substantial project and becomes part of the bid price to be paid by the Town.

Letters of Credit

A letter of credit is an instrument under which the issuer (usually a bank, at a customer's request) agrees to honour a draft or other demand for payment made by a third party as long as the demand complies with specified conditions and regardless of whether any underlying agreement between the customer and beneficiary is satisfied.

The standard fee for a letter of credit is 2% of the total value of the letter of credit although the amount may vary depending upon the "type" of customer. The fee is payable at the beginning of the term. There is also an additional processing fee of approximately \$250.00 to \$500.00 per letter of credit.

Letters of credit may only be drawn down according to the contractual terms that required the posting of the letter of credit. Once the letter of credit is called upon, it converts to a payment to the owner and an interest-bearing loan for the contractor.

Advantages of Letters of Credit

The advantages of a letter of credit are as follows:

1. the letter of credit, until expiry, ensures that the Town has sufficient funds to complete the obligation the letter of credit secures;
2. the Town is accustomed to holding letters of credit for a variety of projects; and
3. the Town is not required to prove "default" prior to remittance of a draw by the bank.

Disadvantages of Letters of Credit

The disadvantages of a letter of credit are as follows:

1. letters of credit must be administered by Town staff which is time-consuming;
2. the cost of posting a letter of credit is borne by the Town as part of the bid price;
3. a letter of credit takes up credit "room" available to a contractor which may mean that qualified contractors are unable to post a letter of credit in respect of a Town project because of the number of letters of credit it has had to post in connection with other contracts. This, in turn, may limit the number of bidders the Town may attract on a given tender or request for proposal;
4. to the extent that a letter of credit ties up a contractor's finances, the contractor may have more difficulty paying its subcontractors in a timely fashion and funding stages of construction pending payment by the Town. This may increase the number of construction liens registered against the Town's property; and
5. a bank, unlike a surety company, will not take an active role in settling disputes and issues between the Town and the contractor who posted the letter of credit. A letter of credit has no guarantee of project completion. It is given only on the basis that the quality and liquidity of the collateral in the event of a demand by the bank is sufficient to compensate the bank.

Self-Insurance

Rather than requiring a contractor to post security, the Town could opt to "self-insure". Where a contractor is not required to post a bond or letter of credit, one may assume that the total bid price will be correspondingly reduced. The money the Town does not spend for security may be used to offset the costs that arise where a contractor is delinquent or defaults under a contract.

The advantage of this method lies with the potential cost savings. However, the disadvantages of self-insurance are more numerous:

1. the potential cost to rectify default or disputes is unknown unless and until an issue arises. If the resolution of the issue involves legal proceedings, the costs are very difficult to estimate but are likely to be significant;
2. other than termination of the contract, there is no financial incentive for the contractor to perform;
3. the actual costs of bonding or a letter of credit may not be deducted from the total bid price so the Town may not see real savings;
4. the notional cost "savings" on other projects as a result of self-insurance may be insufficient to meet the real costs associated with a significant default or defective workmanship on a given project; and
5. the Town may need to do its own financial checks of the bidder which would be resource-intensive and potentially imprecise.

The Need for Effective, Proactive Contract Management

The Town's current procurement documents contain provisions that oblige a contractor to provide performance and labour and material bonds and has a lengthy history of obtaining same. However, the Town has very limited experience in calling on a Surety to rectify deficiencies, declaring that a contractor has defaulted or calling a bond. In particular, the Town called a bond in the last several months. In that instance, the Surety has taken the Town's complaints very seriously and dealt with the contractor expeditiously and forcefully in an effort to forestall a declaration of default by the Town. This instance has highlighted not only the advantages of a bond as a tool to ensure contractual compliance but it has also brought into sharp relief the need for diligent and timely project management during the performance of a contract by staff of both the operational department and the Purchasing and Legal Departments.

FINANCIAL TEMPLATE:

Not applicable.

ENVIRONMENTAL CONSIDERATIONS:

Not applicable.

ACCESSIBILITY CONSIDERATIONS:

Not applicable.

ENGAGE 21ST CONSIDERATIONS:

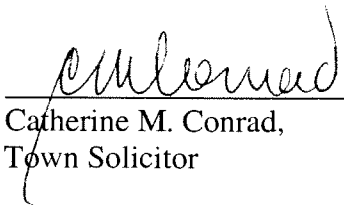
Not applicable.

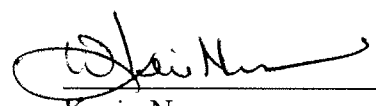
BUSINESS UNITS CONSULTED AND AFFECTED:

Finance, Legal, Operations and Facility Management, Development Services.

RECOMMENDED

BY:


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Kevin Newson
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ATTACHMENTS:

None.