

Letter of Credit Challenges on Construction Projects

CONSIDER TRAVELERS PERFORMANCE AND PAYMENT BONDS AS A BETTER SOLUTION FOR YOUR PROJECT

When it comes to limiting exposure to the inherent risks of construction, choosing the best form of risk management can make a big difference.

Here's why performance and payment bonds have an edge when compared to Letters of Credit (LOCs).

OWNER



Prequalification

Bond: Travelers continually assesses the contractor's business operations, financial resources, experience, organization, profitability of the existing backlog, and management capability to verify that the contractor is capable of performing the contract.

LOC: A bank's primary concern is whether the contractor can repay them for a drawn LOC. There is no ongoing assessment of the contractor's abilities to complete the work.



Coverage

Bond: Performance and payment bonds incorporate the underlying contract documents and guarantee project completion and payment of valid claims from subcontractors and suppliers. The bonds are available up to **100%** of the contract amount. Importantly, payment bonds provide private owners with a lien-free property.

LOC: An LOC may be obtained for any percentage of the contract, but **5% - 10%** is typical. This amount may not be adequate to address all the costs and completion risks associated with a contractor default. An LOC also does not guarantee that subcontractors, laborers, and materials suppliers will be paid in the event of a contractor default and does not protect owners against liens on private projects.



Duration

Bond: Performance and payment bonds remain in force for the duration of the contract including the defective workmanship and warranty period, subject to the terms and conditions of the bond, contract documents, and underlying statutes.

LOC: LOCs are typically date-specific, generally for one year. LOCs may contain "evergreen" clauses for automatic renewal, with related fees. They neither guarantee nor incorporate the contract as bonds do.



Claims

Bond: In the event of default, Travelers employs dedicated claims attorneys and other professionals to help owners complete the project and investigate and pay all valid claims from covered subcontractors and suppliers, keeping your project lien free.

LOC: An owner may draw down on an LOC if a problem on the project arises, with no investigation into the cause of default. However, since an LOC does not guarantee project completion, the owner is left to complete the project and manage payment claims from subcontractors and suppliers on its own.

CONTRACTOR

Liquidity



Bond: Performance and payment bonds typically are issued based on a general security guaranty and do not tie up or diminish the contractor's liquid assets.

LOC: Many contractors may have to set aside an equal amount of cash as collateral to obtain the LOC. For example, on a \$10 million LOC the contractor may have to set aside \$10 million in escrow with the bank to secure the LOC. The contractor would no longer have the use of this cash for general business purposes.

Borrowing capacity



Bond: Performance and payment bonds are provided by licensed surety companies such as Travelers. A surety is not involved with a contractor's borrowing relationships. A surety's credit requirements are separate and distinct from a lender's requirements.

LOC: Larger contractors directly reduce their revolving credit or borrowing capacity in order to obtain LOC instruments. If multiple projects require LOCs, a larger percentage, if not all, of a contractor's borrowing capacity will be consumed by LOCs, thus restricting the use of its banking facilities for other purposes.

Risk Sharing



Bond: Performance and payment bonds provide a balanced three-party relationship between the owner, the contractor and the surety for the duration of the contract. If a dispute arises to the point of a potential contract default, a surety acts as an independent third party in evaluating the dispute, ensuring the positions of each are fairly considered.

LOC: An LOC gives an owner the unilateral right to reach directly into a contractor's balance sheet and remove money while the contractor has no recourse. This negotiating leverage is potentially unfair to the contractor should a valid dispute arise during construction – this leverage is maintained over the life of the contract.

Travelers has over **50** experienced construction services claim professionals available to handle disputes and assist in the claim resolution process.

For more than a century, Travelers has met the surety needs of individuals and businesses through our steady, stable approach.

TO FIND OUT MORE

Contact your local agent or broker today.



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