CONSTRUCTION
EXECUTIVE

# 12th Annual Contractors' Guide To SURETY BONDING

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SPECIAL SECTION:
**CONTRACTORS' GUIDE TO SURETY BONDING**

# 12th Annual Contractors'
# GUIDE TO SURETY BONDING




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SPECIAL SECTION:
**CONTRACTORS' GUIDE TO SURETY BONDING**

# Surety Market Outlook

**THE RUNDOWN ON CAPACITY, AVAILABILITY AND LOSSES FOR EVERY SIZE CONTRACTOR**

BY STEPHANIE ROBICHAUX

The construction industry is feeling the strain from tight budgets and lack of public spending on the federal, state and local levels. With a boost in private spending, the outlook is beginning to look a bit brighter. The Architecture Billings Index was 53 in August, demonstrating an increase in demand for design services, with the highest scores in the Northeast (58.1) and South (55.1). Additionally, the unemployment rate for the construction industry has been steadily declining, according to the U.S. Department of Labor. The unemployment rate for construction was down to 7 percent in September, with the addition of 3,200 nonresidential construction jobs. The temptation is for businesses to overextend themselves as the economy picks up, but contractors that managed the downturn well and remain disciplined are in a good position to attain surety credit and successfully complete work as economic conditions improve.

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*Stephanie Robichaux is communications associate at The Surety & Fidelity Association of America. For more information, email* srobichaux@surety.org.

## SURETY CAPACITY

### SMALL
(LESS THAN $10 MILLION)

For small contractors, surety capacity is abundant and the available capacity is more than the market requires.
*– Henry Nozko W., Jr., President, ACSTAR Insurance Company*

Many would say that both capacity and availability of surety credit for small businesses are too plentiful in parts of the country. With the growing number of programs that are issuing bonds on very limited underwriting and the entry into the small contract market in general by many new players, it is getting very crowded.
*– Thomas M. Padilla, Senior Vice President, HUB International Insurance Services of Albuquerque, NM, President, National Association of Surety Bond Producers*

### MIDDLE
($10 MILLION-$100 MILLION)

When commercial construction activity slowed way down in 2009, the national sureties developed a sharper focus on medium-sized contractors, many regional bonding companies targeted contractors at the upper levels of the $10 million-$100 million range, and some new sureties have been formed that are also competing for contractors in this space. All of these activities translate into sufficient surety capacity for medium-sized contractors.
*– Mike Specht, Vice President – Surety, Minard-Ames Insurance Services / INSURICA*

Virtually every surety writer is operating in the middle market category. The issue going forward will be how long the excess capacity in the middle market exists before companies decide that they can find more attractive returns in other insurance lines. Ultimately, companies with a proven track record of profitably underwriting surety through different market cycles will take a longer view of the business.
*– Stephen Ruschak, President & COO, The Guarantee Company of North America USA*

### LARGE
($100 MILLION-$250 MILLION)

Surety capacity is readily available and at even higher levels. Losses have begun to pick up, a predictable outcome of the downdraft in construction since 2007 combined with too-easy surety credit.
*– Rick Ciullo, Chief Operating Officer, Chubb Surety*

### MEGA
(MORE THAN $250 MILLION)

Contractors with a strong credit profile are enjoying very strong surety industry support. Project sizes are bigger than ever, so this surety capacity is a key advantage for firms to acquire new projects.
*– Mike Bond, Head of Surety, Zurich North America*

## SURETY AVAILABILITY

### SMALL
(LESS THAN $10 MILLION)

The industry surety results have been very positive for most companies in the past few years. Competition for the less than $10 million segment is high. Sureties are offering various "small contractor programs" with limited underwriting information needed to qualify. The SBA program is another option for new and emerging contractors. Surety credit in the less than $10 million segment is readily available for contractors that have maintained their balance sheets during the past few years.
*– Josh Penwell, Vice President, Contract Underwriting, Merchants Bonding Company*

Availability of contract surety capacity in the small market segment is more than ample. More surety companies are abandoning cessionary agreements as they are more willing to carry the full risk associated with their contract surety books. The reinsurance markets are now feeling the pinch of this move toward much greater or complete retention.
*– C. Constantin Poindexter, Managing General Agent, Chief Underwriter Officer, Surety One, Inc.*

### MIDDLE
($10 MILLION-$100 MILLION)

The total surety market is very saturated; however, it is important to distinguish there are two very different segments providing a market. The carriers specialized in the middle market offer plenty of availability and also bring deep expertise and a proven track record of delivering on their commitments. The other group of carriers is new entrants to surety, adding to the availability, but have little or no experience in the market. Contractors should carefully look for carriers that have the experience,

knowledge and financial backing to ensure their success.
*– Robert Thomas, President, Hanover Surety*

## LARGE
### ($100 MILLION-$250 MILLION)
A number of major sureties focus on the large contractor market segment. Sureties are competing heavily in this arena, and the financially sound contractor will not have issues in securing necessary surety credit.
*– Doug Hinkle, Chief Underwriting Officer, CNA Surety*

## MEGA
### (MORE THAN $250 MILLION)
We are seeing more sureties becoming more active in this market, though some have yet to develop the resources often required to support mega, nationally based or internationally based contractors.
*– Larry C. Mitchell, Chief Underwriting Officer Western Region, Construction Services, Travelers*

# SURETY LOSSES

## SMALL
### (LESS THAN $10 MILLION)
Loss activity in 2014 for small to mid-sized contractors appears to be consistent with last year. Efforts by sureties and agents to continually educate contractors about the benefits of managing backlog, bonding back significant subcontractors and identifying onerous contract terms continues to have a positive impact on results. Mitigating risk for the contractor involves not only identifying and minimizing risks in the execution of the work, but also understanding the terms of the contract and selecting the right owners to work for. When interest rates begin to rise during the next few years, we expect to see an increase in claim activity for contractors that have not properly managed their debt loads and do not have proper expense controls in place.
*– Mike Cifone, Senior Vice President – Surety, Hudson Insurance Group*

## MIDDLE
### ($10 MILLION-$100 MILLION)
The losses that were predicted to occur due to the great recession did not materialize. One of the main reasons for this is that, by and large, the surety industry maintained underwriting discipline. Now with the sustained but slow recovery, we have to continue this discipline in the face of mounting pressure for growth.
*– Alan P. Pavlic, President & COO, Old Republic Surety Company*

Overall loss development has been better than planned. There has been some frequency in the subcontractor segment, but there was a lack of larger losses, which should result in reported loss ratios for the middle market at or around 20 percent.
*– Edward Titus, Senior Vice President, Surety Division, Philadelphia Insurance Companies*

## LARGE
### ($100 MILLION-$250 MILLION)
Surety loss activity resulting from the great recession has peaked and is trending downward. There have been a few industry losses in the large segment, but most have been in the small and middle market construction segments. Contractors still remain vulnerable, however, because of weakened balance sheets, and

will need to be careful not to over stretch their resources as the economy and related construction opportunities improve.
*– Rod Williams, Chief Underwriting Officer, Liberty Mutual Surety*

## MEGA
### (MORE THAN $250 MILLION)
The mega segment appears to have emerged from the great recession relatively unscathed. Industry loss data submitted for the upcoming revision to the SFAA Construction Loss Severity Study shows little new claim activity in this category since the early to mid-2000s. Most of the recent claim frequency impacted the middle segment, although with a lower average severity indicating fewer large losses.
*– Alan Clark, Actuary, The Surety & Fidelity Association of America*


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# Executive Insights

**What are the bonding implications as the government promotes joint ventures as a way for small businesses to participate on federal projects?**

**KRISTINE MENDEZ**
DIRECTOR
*Aon Surety*

In a standard joint venture, two or more firms collaborate by sharing risk and pooling resources. The members of the joint venture are jointly and severally obligated to the owner, as are the sureties for the various members. The profits are shared in exchange for the mitigation of each member's risk. This type of joint venture is a partnership of equals.

The 8(a) mentor-protégé program is a federal initiative that pairs smaller, less experienced firms with larger, more experienced organizations. As with a conventional joint venture, the contractual obligations are guaranteed jointly and severally by the mentor and the protégé. The participation of the mentor provides the financial strength that makes surety credit readily available, while the participation of the protégé enables the mentor to access work for which it might not otherwise be able to compete, while sharing expertise and experience with its partner. While this sort of joint venture is not a partnership of equals, the structure provides a vehicle for both parties to earn profits.

**EDWARD TITUS**
SENIOR VICE PRESIDENT, SURETY
*Philadelphia Insurance Companies*

Small businesses form the backbone of our great country. Generally, small contractors are led and managed by individuals who know how to build but, due to relatively limited resources, would surely welcome ideas to create and continually manage their ever-changing business plan.

The surety community is in a unique position to share its experiences with business plan components such as plan of organization; revenue, job cost, overhead and cash flow management; project selection; contract and bond form review; financial and operational systems; and appropriately forming relationships with joint venture partners that have alignment of values with small contractors, including a defined and successful mentoring program.

Surety is a relationship business—small contractors could grow with their surety partners, appreciate their input and remain long-term clients. Not only would the small contractor benefit from a financial perspective, but the surety community would receive the intangible benefit of helping small businesses succeed.

**MIKE SPECHT**
VICE PRESIDENT – SURETY
*Minard-Ames Insurance Services / INSURICA*

Now that the bonding industry understands how the various programs for disadvantaged businesses work, it continues to focus on full disclosure to the contracting officers about the arrangements for bonding via a letter from the bonding company. The sureties' concerns about full disclosure are valid given all the fraud cases we've read about concerning contractor teams that violated the disadvantaged business programs' rules and regulations. Underwriters and sureties want to avoid fines and jail time that have been levied against contractors for improper teaming practices.

The disadvantaged business programs have created opportunities for small contractors and their much larger partners that are required, in many cases, to perform the majority of the work and qualify for all of the bonding. One has to wonder if all parties involved would be better off if the government directed more smaller contracts (ones that disadvantaged contractors can perform and bond on their own) to the small contractors and set aside the big work for medium, large and mega-contractors?

**What efforts are being made to increase diversity in the industry?**

**RICK CIULLO**
CHIEF OPERATING OFFICER
*Chubb Surety*

Diversity has become a top priority to a surety industry hungry for talent and seeking to look more like its customer base. Since May 2013, when The Surety & Fidelity Association of America (SFAA) hosted its first Diversity Summit, this topic has moved from a human resources issue to a business priority and part of a larger talent strategy.

Our customers expect and deserve smart and agile underwriters, people who can quickly size up situations, identify challenges and opportunities, offer solutions and deliver results. These talents are found in people with an array of backgrounds. Broadening our hiring pool was a critical first step to achieving a more diverse workforce.

Successful underwriting comes from making good decisions, and good decisions require diverse perspectives. We have focused on developing individuals and sponsoring organizations to inject more diversity into our succession pipeline and among our leadership ranks.

In an otherwise competitive industry, diversity may be that single area where cooperation creates better outcomes.

**STEPHEN HANEY**
DIVISION PRESIDENT, SURETY
CUO, GLOBAL SURETY
*ACE Group*
CHAIR, BOARD OF DIRECTORS
*The Surety & Fidelity Association of America*

Sureties are diligently partnering with agents and brokers on small emerging contractor mentor programs. The sureties, agents and brokers work closely with government agencies to sponsor and approve these qualified mentor contractors for surety credit risk.

The ultimate goal of the mentor programs is to provide these contractors with increased experience operating their businesses, provide leadership and ensure confidence in their ability to successfully complete projects of their job trade.

Like never before, there is greater awareness of the benefits of diversity. With the influence of varied backgrounds and experiences, a diverse workforce can promote innovation and impart a greater appreciation of the customer's needs.

The concerted effort we're seeing today underscores the surety industry's commitment to bring this higher level of expertise to the market.

**C. CONSTANTIN POINDEXTER**
MANAGING GENERAL AGENT, CHIEF UNDERWRITER
*Surety One, Inc.*

Recruiting from a diverse pool of job candidates ensures a more qualified team. A diverse team is more effective at marketing to consumers from different cultural and racial backgrounds. It also increases our business's premium volume, especially where we encounter an underserved population.

All responsible businesses have likely implemented the Equal Employment Opportunity Commission's most basic anti-discrimination guidelines. This is a good first step to ensuring that diversity is institutionally tolerated. However, a truly diversified workplace requires more proactive measures and a company's dedication to implementing, following through with and monitoring those practices.

It is shortsighted for an insurance organization not to retain a team that can communicate and create meaningful relationships with varied members of society. The imperative must come from the top down. Insurance organizations must not allow outdated preconceptions and prejudices to throw cold water on efforts to create and maintain a truly diverse workplace.

# Executive Insights

**What efforts are being made to increase diversity in the industry?**

**JACK A. CALLAHAN**
PARTNER, CONSTRUCTION INDUSTRY PRACTICE LEADER
*CohnReznick LLC*

With all the best intentions, federal, state and local agencies continue to set high minority participation goals. However, the reality across the country is that there is a shortage of minority contractors with the financial and technical experience required for many of the larger and more complex projects.

Bond readiness programs have been established for minority contractors, but much more has to be done. A contractor can no longer rely on an agency's prequalification process; they must independently assess the qualifications and the capabilities of the minority contractor.

All contractors must be extremely vigilant in their contractor selection and oversight process. The prime contractor must assure the minority contractor is meeting "commercially useful function" requirements. Any efforts on the part of the prime contractor to "help" the subcontractor have to be viewed in light of how these actions will be perceived by the enforcement arm of the agency for which the contractor is working.

**ANTONIO C. ALBANESE**
VICE PRESIDENT – SURETY
*Freedom Specialty Insurance Company, a Nationwide Insurance® Company*

The more diverse we are, the better view we have of the markets we serve. The insights we gain from our associates and various community groups allow us to look at new approaches and offer different services to our customers.

Within the industry, the SFAA has been working with INROADS to recruit a diverse cross-section of students from various colleges, bring them into the organization and provide them with professional development, including training, coaching, résumé writing and interview skills. This brings a spectrum of students into the industry early in their college years and exposes them to the insurance industry as a potential career.

Freedom Specialty is fairly new to the surety market, and diversity in our workplace has set the tone for our operation as it grows. It is important to build a varied associate community to support our ever-changing marketplace. This past summer, we worked with INROADS to hire an intern for our New York office, and we plan to continue to do so in the future.

**STEPHEN C. RUSCHAK**
PRESIDENT & COO
*The Guarantee Company of North America USA*

We must do a better job of attracting, developing and retaining top professional talent who might not be considering surety or insurance as a viable career path. During the last 20 years, the industry has stopped formally training future talent, which was how many of us started in the business.

The failure to bring new talent into the surety business on a widespread basis has resulted in a lack of diversity in the industry. It is encouraging to see the commitment to promoting diversity by SFAA, the National Association of Surety Bond Producers and their member companies. In 2013, SFAA held its first Diversity Summit to reaffirm the industry's commitment to diversity, and to get participants' input on a long-range industry diversity plan. SFAA has put together a Diversity & Inclusion Strategy Toolkit for member companies and is planning the second Diversity Summit for May 2015.

It will take time for noticeable change to appear; however, the initial steps are being taken at the individual company level.

# Executive Insights

## How does safety impact bonding?

### ROD WILLIAMS

CHIEF UNDERWRITING OFFICER
*Liberty Mutual Surety*

While surety underwriters may not typically delve into a contractor's safety program and record in depth, an underwriter is concerned with and does evaluate the overall abilities, results and professionalism of a contractor client. In that sense, safety is important. From a performance perspective, a good safety program means more secure, productive employees and minimal impact to project scheduling.

Financially, there is a lower threat of adverse consequences from the economic impacts of a bodily injury or property damage accident, including potential litigation. Perhaps even more important, a well-planned and executed safety program with a good track record is a reflection of a well-run organization. The implication is that the contractor may be just as methodical and professional in other areas critical to success and of interest to surety underwriters, such as project selection, risk analysis, estimating, subcontractor prequalification, cost accounting and internal controls. A contractor should be proud to share its safety record with the surety.

### DOUG HINKLE

CHIEF UNDERWRITING OFFICER
*CNA Surety*

Employee safety is fundamental to the long-term success of any business, but particularly important to a construction business where jobsite conditions and practices, left unmanaged, can present high risk of injury to employees.

The employee base of a construction company can represent a significant investment by the owner. These employees are an essential asset and generally are critical to the success of the business.

Investing in programs and practices that build a safety culture protects the employees and promotes greater jobsite productivity and job performance. Strong job performance leads to strong overall company performance.

In its evaluation of surety support for a construction company, a surety company considers a number of business factors in its underwriting process. Of all the factors considered, company performance is one of the most important in determining surety support levels.

## In what ways do surety professionals provide market intelligence to their contractor and subcontractor clients?

### LARRY C. MITCHELL

CHIEF UNDERWRITING OFFICER
WESTERN REGION, CONSTRUCTION SERVICES
*Travelers*

Surety underwriters can provide actionable market intelligence to their clients in a variety of ways. The ability to do so is enhanced by the metrics the surety can draw upon from its existing client base, which can be used to spot trends over a broad spectrum of contractor sizes and types, as well as diverse geographic areas. This data also can be utilized to benchmark clients against an anonymous sample of other firms doing the same size and type of work, and to provide feedback as to where the contractor may be under- or over-performing.

Surety professionals also can share failures in certain classes of business and ways to mitigate exposure to them, as well as structural shifts in owner relations. Ideally this is combined with having surety personnel in "local" markets who are experienced and knowledgeable about local owners, contractors and economic conditions and can meet regularly with their clients. Additionally, the surety professional should share knowledge based on construction industry topics and issues with techniques and support to mitigate or remove those risks.


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# Executive Insights

**In what ways do surety professionals provide market intelligence to their contractor and subcontractor clients?**

**MIKE BOND**
HEAD OF SURETY
*Zurich North America*

Well-managed contractors have long realized that working with a strong surety offers strategic advantages in the marketplace. Surety professionals deal with many customers, support projects of all sizes, and can offer their clients insights that often make the difference between success or failure.

Surety professionals can help contractors find work to help fill their backlog. For example, through an existing customer network or professional association, the surety can recommend a strong trade contractor to a general contractor. These recommendations are often a "win-win," as the general contractor is looking for reputable subcontractors that can complete work successfully. The trade contractor then establishes a working relationship with a strong general contractor that may need its help on other jobs.

Another important area is localized construction industry knowledge. Each jurisdiction presents contractors with challenges in areas such as contract language, demanding owners and onerous bond forms. Surety professionals work with these issues on a daily basis and help their clients avoid unnecessary risk.

**ROBERT THOMAS**
PRESIDENT
*Hanover Surety*

Typically, contractors are not experts in surety bonds or insurance coverage, so they turn to their local independent agent to help them find the right surety provider for their business.

Agents who specialize in surety spend a significant amount of time staying on top of key trends, understanding the implications of risks to contractors and their bonding needs, working with their surety carrier partners, and then offering advice to their contractor customers. These agents provide value through their expertise and professional business relationships with their contractor customers.

The best surety carriers offer separate risk mitigation units that work hand in hand with contractors' agents and even their CPAs to ensure any surety risks are addressed before claims are made. Strong agents and carriers also can work together to help contractors through government and legal affairs.

Together, agents and carriers offer experience and market insight that is critical for helping contractors manage and grow their businesses.

**JOSH PENWELL**
VICE PRESIDENT, CONTRACT UNDERWRITING
*Merchants Bonding Company*

Construction is simply a risky business. Properly managing the risk on a construction project is critical for the project to be completed successfully. Surety underwriters are trained to evaluate the risks associated with various contractors. Surety underwriters also will determine the appropriate levels of projects and programs that a contractor should undertake.

Surety companies have portfolios of contractor clients that typically range from general contractors to specialty trade subcontractors. The size of these companies also can range from small to large. Surety companies have a tremendous amount of historical data and can use analytics to provide benchmarking for their contractor clients.

Surety underwriters also are trained to review contracts and can help negotiate unfavorable terms and conditions. Surety companies will be able to assist in other ways such as referrals for a certified public accountant or a banker. Contractors will experience a much higher likelihood of success by teaming up with a professional underwriter and surety agent.

# Executive Insights

**In what ways do surety professionals provide market intelligence to their contractor and subcontractor clients?**

**ALAN P. PAVLIC**
PRESIDENT & COO
*Old Republic Surety Company*

Surety professionals, both agents and company representatives, must keep abreast of the changes in the construction environment in their locality. Oftentimes the surety professional knows as much or more than the contractor does about the local marketplace in terms of projects that will be bid, new public works programs, and new entrants or financially challenged contractors.

Because the agents are closer to the contractors, they are in the best position to communicate market intelligence to the construction community. As company representatives, we have to get out and meet with our contractors and let them know what we are seeing on a local and national basis. Due to the diverse sources of information that we are provided with, our focus is broader and we are in a better position to provide contractors with big picture information that impacts their local businesses. This can be done through newsletters, emails or other written communication; however, the best and most effective method is a face-to-face meeting.

**HENRY W. NOZKO, JR.**
PRESIDENT
*ACSTAR Insurance Company*

Sureties are in a good position to provide market intelligence to their contractor clients. For example, if a nationally operating obligee has a penchant for regularly waging inflated delay claims or liquidated damages against contractors completing the obligee's construction contracts, a surety might warn a contractor of the potential risk. The contractor would then have the benefit of the information when considering entering into a contract with the obligee in its geographic area.

Additionally, a contractor first entering into a new operating area might benefit from a no-cost debriefing from its surety about the peculiarities in the law of the new jurisdiction, which might differ from most other jurisdictions. For example, nothing will be considered outside the four corners of the contract document in one jurisdiction, but others may accept extrinsic evidence to establish the intention of the contracting parties, which might significantly change the ruling in a dispute.

The experience of a surety in such matters could be a valuable resource.

**MIKE CIFONE**
SENIOR VICE PRESIDENT - SURETY
*Hudson Insurance Group*

When the relationship with the surety professional is built on trust and respect, it gives the contractor an opportunity to flourish when times are good and to survive when times get tough.

Surety professionals have access to data that provides insight into regional and national trends in construction activity, which can be useful for contractors in projecting manpower needs and anticipating adjustments to equipment purchases.

Mitigating risks is another key to a contractor's survival. Several areas where a surety professional can help a contractor reduce risks are: identifying and modifying onerous contract terms such as unreasonable indemnity clauses, excessive warranty periods or high liquidated damages; identifying owners that may be more difficult to work for due to stringent demands and slow cash flow; and providing local market knowledge and identifying risks in new territories that a contractor may be interested in expanding into.

Successful contractors incorporate the knowledge and expertise of their surety professionals in the development and execution of their strategic plans.

# Executive Insights

**In what ways do surety professionals provide market intelligence to their contractor and subcontractor clients?**

**THOMAS M. PADILLA**
SENIOR VICE PRESIDENT
*HUB International Insurance Services of Albuquerque, NM*
PRESIDENT
*National Association of Surety Bond Producers*

Professional bond producers are in the unique position of having a wide variety of market intelligence that is specific to their own geographic area. Knowledge of owners, competition, local conditions and many other variables that come into play on each job is extremely valuable. Their prior experiences with many contractors and various projects give them a unique perspective and enable good producers to be valuable advisors to contractors.

The relationships that professional bond producers enjoy with banking, accounting and legal professionals are an added benefit to clients. Equally important are the relationships that only true bond producers have with the underwriting community and their ability to match clients with the best surety partners to help them succeed.

No other professional has the wide range of experience that is specific to the local area while understanding the broader picture necessary to advise a contractor wisely.

**MICHAEL J. MITCHELL**
VICE CHAIRMAN
*The Graham Company*

In the surety industry, we are privy to classified financial information—often for competing contractors and subcontractors—that we cannot divulge. However, surety professionals can still speak in generalities about the financial state of the subcontractor pool and surety marketplace, which can prove helpful to many contractors.

Surety professionals can, and should, provide information on:

- financial benchmarking in comparison to other similar contractors;
- the state of the surety marketplace (e.g., which sureties are aggressive and which sureties might have loss activity that is making them extra conservative);
- the building sectors that currently offer the greatest opportunity;
- insurance trends, such as the rise of contractor controlled insurance programs and the development of billing rates for personnel that are considered reimbursable;
- joint venture strategies; and
- potentially troubled owners that may be unreasonable or unscrupulous and could harm the financial welfare of a client.

**MICHAEL MARINO**
PRESIDENT
*American Global, LLC*

Surety professionals are often looked at by their clients as business advisors. Contractors today operate in a business environment with increased competition, increased complexity and compressed margins. While it is critical to maintain the confidentiality of proprietary client information, surety professionals have benchmarking information and perspective on macro-industry trends that can be very helpful to their clients.

Strong market intelligence on critical topics such as changes in procurement models, general contractor and subcontractor profitability trends, as well as positive and negative owner trends, can add significant value to their clients. This guidance can influence how contractors penetrate new markets or evolve their operational strategies.

In today's increasingly competitive business environment, contractors should expect their surety professionals to possess market intelligence that can be meaningful to how they run their business. CE

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• Our Specialty division provides capacity for international and U.S. multinational customers. Through affiliated companies and fronting relationships, we have business in 40 countries, making us a leading provider of foreign bonds for U.S. companies, and domestic bonds for foreign companies operating in the United States.

• Our small to middle market division, provides contractor program capacity up to $15 million ($25 million in major cities).

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Liberty Mutual Surety works closely with Liberty International Underwriters (LIU). LIU specializes in providing the most comprehensive solutions for your clients' coverage needs and offers a full complement of specialty construction products, including: property construction, primary casualty, excess casualty, environmental, project cargo, management liability, professional liability and railroad protective liability.

Bringing knowledge that's unmatched in the industry, LIU focuses on complex projects and collaborates across product lines, including surety, resulting in superior service.

When you choose Liberty Mutual, you'll work with one company to cover your clients' construction risks, from start to finish.

For more information, contact your independent agent or broker or visit *www.libertymutualsurety.com* or *www.liu-usa.com.*

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The Hanover Insurance Group®

# Hanover Surety's Winning Combination:

## Financial Strength and Deep Expertise

As a construction professional, you understand how to plan and manage complex projects—including the importance of purchasing surety protection against the many risks inherent in your business. The right surety bond coverage provides confidence and peace of mind to your customers, contractors and vendors, while protecting your company and reputation when the unexpected happens.

Our people are our biggest asset. They create value through their expertise and customer commitment. Perhaps most important to you, is that our team at Hanover Surety includes many of the industry's most knowledgeable and experienced professionals, who offer unparalleled market knowledge, underwriting insight and responsive service. Professionals like Ralph Giordano, the director for contract surety for our Northeast Region.

"After 22 years at Chubb Insurance, I joined Hanover Surety because I recognized the company's operating model as being truly unique in the business," said Giordano. "At every level of the organization, there is the understanding that no two contractors and no two construction jobs are alike, and there is the commitment to create solutions that are tailored to meet the demands of every different company and building project."

Another key player on our professional team is Peter Quinn, regional director for contract surety for our Central Region. Like Ralph Giordano, Quinn's superior analytical skills and insight are based on many years' experience as an underwriter and risk manager in contract surety, including at St. Paul Surety (Travelers), XL Group, and W.R. Berkley.

"When you know contract surety, you understand why Hanover Surety is a very special company and how they add value to the bonding process," said Quinn. "It's a company where financial strength, experience, and strong industry partnerships create real synergy to meet the needs of the individual contractor and their specific jobs."

Michael Pete, chief underwriting officer at Hanover Surety, agrees. "We are committed to developing and delivering the best bond solutions in the industry," Pete said. "We want contractors to know that when they choose Hanover Surety, they are choosing a carrier with the strength, underwriting experience and targeted solutions that add value to every transaction."

With the countless details and risks involved in managing your construction projects, make sure you have the right surety bond and right surety team to protect your business. Experienced contractors who know the ins and outs of the business recognize the importance of working with carriers who are equally experienced and knowledgeable about the intricacies of construction surety bonding. Together, they share a commitment to deliver solutions that meet your unique needs.

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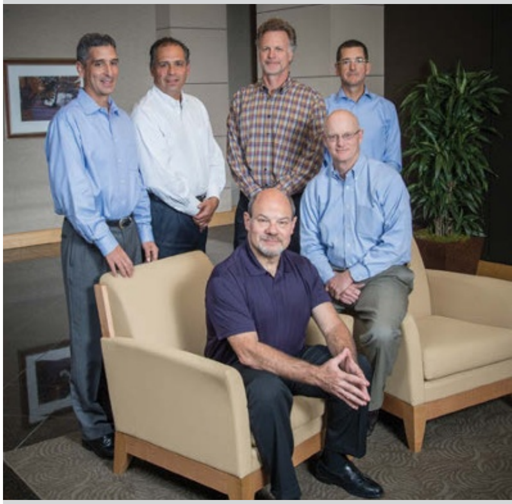

### Company Highlights

We know how to help our construction customers manage complex projects and prepare for the unexpected, too, because we've been managing surety risks for more than 100 years.

At Hanover Surety, we've earned our place among the top 15 surety providers in the country, based on our long experience and financial strength, including an "A" rating from A.M. Best and a Group Treasury listing of $181.3 million.

We are proud of the Hanover Surety local leadership team that is recognized to be among the best in the business, including:

**Michael Pete,** Chief Underwriting Officer
**Peter Quinn**, Central Region
**Brent Davis**, Southeast Region
**Tony Yasilli,** Southwest Region
**Ralph Giordano**, Northeast Region
**George Muñana**, West Region

# HANOVER SURETY BY THE NUMBERS...

TOP 15
Surety Writer

Capacity for Commercial Surety Accounts UP TO
$75 million

Fortune 1000®
"A" RATED COMPANY

20 Surety
Offices Countrywide

Over
$77 million
in Surety Written Premium

Specializing in Surety Bonds
since 1907

Capacity for Contract Surety Accounts up to
$100 million

88
Local Surety Experts

1 OF THE 40
oldest companies listed on the New York Stock Exchange

93% of Hanover claimants would recommend The Hanover to a friend

Group Treasury listing of
$181.3 million

OVER
650
Current Contract Surety Clients

We write in
all 50 states

Over
26,000
Bonds written in 2014

2009
Introduced BONDirect for online quote and issue

...ADDS UP TO **CREATING GREATER VALUE.**

The Hanover Insurance Group®

CORPORATE
**PROFILE**

Old Republic Surety Company

# Bring It On!

Responding to the bonding needs of middle market contractors is one reason why Old Republic Surety Company has increased our bonding capacity tenfold since 2004. With our bonding capacity currently at $50MM, Old Republic Surety Company is positioned to assist the construction industry with bond programs based on flexible, common-sense underwriting. We write contract bonds in all 50 states and we're ready. ***Bring it on!***

We've got an option for smaller, growing contractors. Our FastBond 500 program, based on credit score, offers a quick, flexible answer for a smaller bond, and opens the door for small contractors wanting to grow. Coordinate our FastBond 500 program with essential underwriting elements to easily transition into a standard bond program. Better yet, you'll keep the same underwriter and relationship as you grow with us.

Need help setting up a standard bond program? ***Bring it on!*** We'll prequalify you so you're poised and ready. We coach contractors of all sizes on what they need to succeed. With a healthy, pre-qualified bond program, contractors have flexibility to bid more often, bid on more variety or even choose to bid directly. Prequalification also expedites the bond portion of the bid process, opening up more opportunities. If you need help positioning yourself with the right pieces in place, we'll help you get that done. ***Bring it on!***

Want a human element to underwriting your bond program? ***Bring it on!*** That's all we do. A lot of surety companies use an algorithm that calculates your risk based on a set of parameters programmed to determine the viability of your bond program. At Old Republic Surety Company, we don't use a computer-based program that spits out a "yes" or a "no" for your contract bonds. Each opportunity is unique . Our underwriting is completely human. Our staff, not computers, evaluate your program to determine your qualification. Your business' strengths are unique, and you deserve the consideration we've been trained to provide. Quick, expert underwriting with a completely human interface is what you can count on from Old Republic Surety Company.

We have a nationwide network of appointed professional agencies that understand the value of our common-sense underwriting and the importance of our financial strength. To find an agent or contact a branch office near you, visit *www.orsurety.com*.

$50,000,000 of bonding capacity with Old Republic Surety Company! – ***Bring it on!***

## Company Contact

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## Company Highlights:

- "A" Rated with AM Best
- $50MM Bonding Capacity
- Licensed in All 50 States
- Writing Surety Bonds Since 1923
- Subsidiary of Old Republic International

FastBond 500

## FastBond 500 Highlights:

Designed for contractors that may need their first bond, or that only have occasional bond needs.

**Key FastBond 500 Attributes:**

- Local underwriting
- Primarily based on credit score
- Under $250,000 - immediate response
- Limits $250,000-$500,000 - quick response time
- Ideal for accounts with no formal financial presentation
- Subjectivity is flexible
- All construction trades


$50,000,000 of Bonded Capacity...
Bring It On!
Old Republic Surety Company has increased it's bonding capacity 10-fold since 2004!
Today, with $50MM in capacity, we can handle the bonding needs of your middle market and larger contractors.
The economy is improving, your customers are growing, and we're ready!
Have a contractor that needs some room to grow?
Bring It On!
www.orsurety.com
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OLD REPUBLIC SURETY COMPANY

# Managing Growth: Why Some Contractors Succeed And Others Fail

BY AARON DeROSS

The construction industry has faced six years of economic downturn. While some firms are thriving, the vast majority of companies have experienced declining revenues, margin pressure, challenging projects and balance sheet deterioration. Now, construction company owners and senior leaders are focused on managing profitable growth after the recession.

The key to any successful business is developing a written business plan and communicating it to the entire organization. The plan needs to be proactive and forward thinking, with a focus on market trends and future opportunities. The senior leadership team needs to be aligned with its strategic business and financial partners—including sureties, bankers, attorneys and CPAs—which collectively can share best practices and add tremendous value to contractors looking to grow.

Many firms experience the age-old issue of growing too fast. Controlled growth is the key to long-term success. Contractors should avoid having too many new areas of focus in their business plans, such as taking on a new type of work within a new geographic territory and adding new, untested people.

**Diversification**

Diversification is another key to managing growth. The construction market remains very fragmented, with some markets growing and others declining. Successful contractors quickly identify emerging markets and take a very methodical approach to market entrance. They also spend ample time researching new markets and construction disciplines. Contractors should pursue smaller jobs before jumping

# Aon Construction Services Group

Empowering Results for Contractors


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## Company Highlights

Our firm's Construction Services Group delivers services that support profitability, continuity and growth for our clients:

**Profitability**: Optimizing risk management spending, providing strategic support, creating innovative risk transfer solutions and reducing cost to transform the risk management function into a profit center for your firm.

**Continuity:** Delivering superior coverage and program design, as well as post-loss support to help reduce volatility, protect your balance sheet and empower stability.

**Growth:** Providing the best risk solutions and hands-on expertise to support and drive the growth of your organization successfully across industries, channels and geographies, including facilitating connectivity and supporting your firm with opening new markets.

Aon's Construction Services Group is the preeminent provider of risk and human resources solutions to general and specialty contractors, project owners, and industry stakeholders.

As the segment leader, Aon provides an unparalleled platform to serve the risk management needs of global contractors, an expansive network of offices to support service delivery for specialty firms and large infrastructure projects, and the risk management industry's leading global network delivered through collaborative colleagues who specialize in construction.

As the leading provider of risk management, insurance and surety solutions to large, global contractors, regional trade firms and the specialty contracting sector, Aon provides brokerage services to more than 45 percent of the *ENR* 100. However, more than 80 percent of our client base is in the middle market. Our Construction Services Group leverages the placement volume, broking expertise and service infrastructure of Aon to provide industry-leading terms and conditions, pricing and claims support.

### SURETY AND PERFORMANCE SECURITY

Aon specializes in structuring bond programs that deliver the maximum credit necessary for contractors to capitalize on strategic opportunities. Every year, Aon provides more clients with more solutions to challenging bonding problems than any other service provider. In fact, we write bonds for 25 percent of the *ENR* Top 400 contractors, as well as mid-size domestic firms and large organizations with multinational operations.

### PROJECT SOLUTIONS

Aon enjoys a rich history of successfully developing and managing contractor-controlled insurance programs (CCIPs), owner-controlled insurance programs (OCIPs) and risk management programs for capital expenditure (CapEx) investments. Our firm is the leading provider of wrap-up insurance placement and administrative services nationally, managing an estimated 30% of all program volume nationally. Over the last 15 years, the 120 colleagues on this team have managed more than 10,700 projects and are responsible for coverage of more than $80 billion of work in progress.

> *"Diversification in backlog allows the inevitable bad job to be isolated, ideally minimizing the impact on the balance sheet.*

into new areas with both feet. As businesses expand their geographic footprint, managing projects and labor from a distance becomes more difficult. Diversification allows contractors to put more cushion in their bids, with the goal of increased margin realization.

When entering a new territory, successful contractors find a local joint venture partner. This allows them to spread risk and gain access to additional talent, subcontractors and balance sheet resources. The "all eggs in one basket" approach often does not pan out in today's zero-tolerance environment. Diversification in backlog allows the inevitable bad job to be isolated, ideally minimizing the impact on the balance sheet.

**Capital**

Adequate capital is another fundamental concept for managing growth. Successful contractors have built up a balance sheet over the years with resources that give financial partners the flexibility to support the growing business. In many situations, the work program and desires outpace the balance sheet for a period of time. It is critical for the contractor to communicate the roadmap to its financial partners so they can quickly develop a new strategy if the plan goes off course.

**Job Selection**

Job selection is critical to running any business and managing growth. Successful contractors fully review contract terms and conditions and work closely with surety partners in a collaborative effort to negotiate unacceptable risk out of their contracts.

Knowing where the fundamental risk lies and how much risk a firm can tolerate is half the battle. A great deal of time always has been spent on building the project within the specifications, but it is becoming increasingly more common in today's environment to ask if the project can be built within the terms and conditions of the contract.

**Technology**

In the ever-changing world of technology, cost and accounting systems are essential in managing growth. Information is power, and the more information project managers and senior management have at their fingertips, the better their decisions will be. The systems available today continue to improve, and contractors should select the applications that fit both their immediate and future needs. Sureties and CPAs can be great resources for recommending what systems might be a good fit for managing growing organizations.

**Talent**

Talent management always has been, and will remain, a critical driver in managing a company's growth. The construction industry is experiencing a rapidly aging workforce and, not unlike other industries, is struggling to attract new talent. The firms with established training and mentoring programs will not only grow, but will grow profitably.

Despite the economic headwinds, signs of optimism exist as margins begin to tick up in certain markets and pipeline reports are growing for a number of construction firms. Historically, construction failures and surety losses increased after a longer-term construction recession, as balance sheets eroded with increased debt to service while businesses did not pare back overhead fast enough. A successful contactor manages overhead during difficult times by maintaining only its best workers and trimming expenses.

If a contractor stays focused on its business plan and can execute it while adhering to the aforementioned guidelines, it will be in a position to manage growth successfully.

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FREEDOM SPECIALTY
INSURANCE COMPANY®
a Nationwide Insurance® company

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Antonio Albanese

## Company Highlights

- A.M. Best Rating of A+ (Superior), FSC XV[1]
- A Nationwide® Insurance company—Nationwide® is U.S. Treasury listed and approved with a T-listing in excess of $1.1 billion, one of the largest in the industry[2]
- 50-state capacity
- Flexible, multi-tiered rating plan
- National organization offering a full-range of surety products to meet all needs from small to middle markets and ultimately large national firms.

[1]Affirmed June 2014
[2]Nationwide Mutual Insurance Company®, 2014, http://www.fiscal.treasury.gov. Coverage is provided by Nationwide Mutual Insurance Company®and affiliated companies.

# Freedom Specialty: Strength. Stability. Solutions

Freedom Specialty represents a wealth of experience focused on surety and specialty liability insurance ranging from management liability to cyber and professional liability. Our surety operation specializes in both commercial and contract surety bonds. Our focus is on developing a close working relationship with our agents, brokers, and principals in order to ensure a consistent underwriting approach to mitigate losses.

Freedom Specialty is backed by Nationwide®, a Fortune 100 company the U.S. Treasury listed and approved with a T-listing in excess of $1.1 billion[2], one of the largest in the industry. Add to that an A.M. Best Rating of A+ (Superior), FSC XV[1] and an S&P A+ rating, and you can be sure you're working with one of the most financially stable companies in the industry.

Since we opened our doors in 2007, we've experienced tremendous growth. After only six years, we reached $1 billion in cumulative direct written premium.

We're adding products each year to our already comprehensive suite of surety and specialty liability solutions. We're deepening and growing our expertise. And we're broadening our reach with coast-to-coast accessibility through our offices in New York City, San Francisco, Chicago, and Atlanta.

Our expertise allows us to be innovative. Our relationships allow us to understand the needs of your business. The result: unique surety and insurance products, and an analytical approach unrivaled by any other firm. We are the source for comprehensive surety bond solutions, including 50-state capacity and a flexible, multi-tiered rating plan.

When you work with Freedom Specialty, you know you are working with a strong and stable carrier. Backed by Nationwide®, with the highest financial ratings possible, our strong foundation means we will be there for you.

# Differences Between a Surety's and an Owner's Prequalification Process

BY BOB STAPLES

Contractor prequalification is not a project owner's primary function. While the owner is responsible for orchestrating the bid and payment process, it should delegate the prequalification process to licensed reputable sureties as part of its overall risk avoidance practices.

No matter how large a contractor is or how long it has been in business, the possibility of failure persists. Each phase of a project requires several independent parties working together to ensure success.

Three basic factors lead to subcontractor failure.

1. Poor management, such as inadequate accounting, financial and project management systems; changes in ownership, management, personnel or business strategy; rapid over-expansion in volume or into new geographies; or poor owner or project selection.
2. Labor and materials shortages or unrecoverable cost escalations.
3. Uncontrollable factors, such as weather problems; economic downturns; changes in jobsite conditions; the death, illness or departure of a key employee; or another project owner failing to pay.

Most project owners that engage in prequalification practices typically check credit reports such as Dunn & Bradstreet, talk to familiar subcontractors or suppliers for references, and then apply the results of an in-house, financially derived, ratio formula to reach a "prequalified work program" number. This prequalification process is rudimentary compared with the in-depth process used by sureties:

- **Thorough analysis of the company's financial condition.** This includes through examination of financial documentation and work-in-process. Depending on the surety program request, the results of the financial analysis can readily determine

# Hudson Insurance Group

Responsive Contract and Commercial Surety Solutions

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**Commercial Surety:**
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Wayne Gutches, VP Commercial Surety
Deb Nelson, VP Commercial Surety
p: (888) 400-5505

**Specialty Contract Surety:**
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Juli Dahlgren, VP Specialty Contract
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## Company Highlights

- Rated "A" (Excellent) by A.M. Best Company
- Licensed in 48 states and the District of Columbia
- Treasury Listing of $41,395,000
- Participating surety in the SBA's Surety Guarantee Program
- Regional expertise and superior client service
- Represented by select surety agents

Hudson Insurance Group is a specialty insurance group that writes business on an admitted basis through Hudson Insurance Company and a non-admitted basis through Hudson Specialty Insurance Company and Hudson Excess Insurance Company. Hudson offers a wide range of property and casualty insurance products to corporations, professional firms and individuals.

Hudson Surety is comprised of an experienced group of underwriters with deep industry knowledge. The vast experience of our team enables us to offer creative solutions to our clients. We work closely with a select group of agents throughout the United States to provide superior service.

Hudson Surety provides surety bond products for standard contract surety, commercial surety and specialty contract surety. We have the expertise to work with all types of contractors and the financial strength to grow with our valued principals.

### STANDARD CONTRACT SURETY

Regional knowledge of the construction market place has been an important element of our underwriting approach. Our contract underwriters work closely with our agency partners to understand our customers' needs in order to develop a surety program that supports their plans. Our client base consists of general contractors as well as many of the specialty trade contractors.

### COMMERCIAL SURETY

Exceptional customer service and a broad appetite have driven the success of Hudson's transactional commercial surety business. Our products include all types of license and permit bonds, customs bonds, public official bonds, court bonds and miscellaneous commercial bonds.

### SPECIALTY CONTRACT BONDS

For contractors that may not fit the underwriting criteria of the standard surety market due to years in business, infrequent bond needs or an unprofitable project, Hudson offers an alternative solution. Utilizing tools such as collateral and funds control, Hudson supports the bonding needs of the contractor until they qualify for our standard surety program. Hudson also participates in the SBA Surety Guarantee Prior Program.

whether the contractor has the appropriate financial horsepower to undertake the proposed project, particularly if project difficulties appear.

- **Thorough analysis of the contractor's prior work history and work-in-progress**. This includes reference checking with subcontractors, suppliers and project owners. The surety will investigate the nature of the project under consideration and the applicable contract terms to ensure the contractor has the appropriate experience to complete the project on time and within budget.
- **Evaluation of the contractor's organization and management structure.** The surety will examine the firm's employment history, track record, educational background, objectives and attitude toward risk, as well as character and reputation of key employees. Management continuity is reviewed in the event key employees pass away or become incapacitated to ensure the business will continue and, most importantly, complete all remaining work on hand.
- **Review of the firm's management and control systems.** Can the contractor determine the status of its contracts and translate this information into a financial display? Is its internal cost system being used and, if so, how, by whom and with what frequency? Can the firm's management team identify problems early and take steps to resolve those problems without delaying the project or exceeding the original budget?
- **Examination of the contracting firm's history of bidding jobs that reflect its skill set at the right price.** Does the firm properly control activities on the jobsite, such as labor productivity, material costs, equipment utilization and job component scheduling?

As illustrated, surety prequalification is a rigorous, specialized process by which the surety assesses the contractor and supports its judgment by issuing performance and payment bonds. Performance bonds assure the contractor is qualified to perform the work and protect the project owner from financial risk should the contractor default. Payment bonds assure that specified laborers and suppliers associated with the project will be paid.

While the primary benefit of the surety's prequalification is transferring contractor default risk to the surety company, it should be noted that surety bonds are not traditional insurance products. Unlike alternatives to surety products, surety bonds provide the project owner with complete transfer of project default, not simply a cash payment that leaves issues of contractor replacement and supplier payment in the hands of the project owner. In general terms, a surety will not extend itself based on the perception of a contracting firm's potential, but rather it will extend credit based on the contracting firm's past accomplishments.

Beyond having surety professionals involved with the overall process of successful contract completion, other benefits to prequalified and bonded contractors include:

- increased assurance of having contractors complete their contracts on time and within budget;
- a shield from paying twice for the same work items if the contractor fails to pay subcontractors and suppliers; and
- increased likelihood that a financially troubled contractor will complete its bonded jobs because business and personal assets are on the line via corporate and personal indemnity requirements from surety companies.

Because there are so many surety companies in the marketplace, project owners should investigate the quality of a contractor's surety as part of its risk assessment process. Several sources rate insurance companies, including A.M. Best, Standard & Poor's, Moody's, Fitch Ratings and Weiss Ratings. An additional resource is the U.S. Department of Treasury's T-List. Surety agents also can be an excellent source on how to mitigate contractor risk.

With so many resources available to project owners—and with the primary emphasis on contractor prequalification through a reputable surety—contractor default mitigation becomes a manageable process, which greatly enhances the chance of successful project completion.

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*Bob Staples is senior vice president of surety for Allied World North America. For more information, email* robert.staples@awac.com.

# Why Is Underwriting So Complicated and Thorough?

BY KEENAN LEHMANN

Surety companies prequalify contractors to guarantee the company has the capital, capacity and character to complete the project. The surety will use its money, up to the amount of the bond, to make the owner of the construction project whole if the contractor does not perform or does not pay its suppliers or subcontractors. To offer that guarantee and stand behind the contractor, a good surety underwriter will understand the complexities of construction accounting and use a thorough underwriting process.

Construction is one of the riskiest of all industries, with a reported one in four failure rate. A surety bond is a three-party risk transfer agreement that shifts the burden of construction risk from the project owner to the surety company. The surety bond assures the owner that a prequalified contractor will perform a specific contract.

The three primary types of construction surety bonds are bid bonds, performance bonds and payment bonds. A bid bond assures the owner that the bid was submitted in good faith and that the contractor submitting the bid has been properly vetted by an independent party and is qualified to successfully complete the project. The performance bond provides the owner with protection from financial loss in the event of a contractor default. The payment bond assures the owner that, at completion, the project will be free of liens by guaranteeing the contractor will pay covered subcontractors and suppliers throughout the project.

**Surety Bonds Vs. Traditional Insurance Policies**

Project owners and contractors sometimes confuse a surety bond with a traditional insurance policy. While they both are provided by insurance companies and are licensed and regulated by state insurance departments, surety is a unique form of insurance in which the surety company's financial resources back the contractor's commitment to enter into a contract with an owner. While traditional insurance and surety premiums are actuarially based and take losses into consideration, traditional insurance works by pooling risk. Surety bonds shift the risk from the project owner to the surety, and the premium for a surety bond also serves as a fee for prequalification services.

Unlike other types of insurance policies in which losses are expected, surety bonds are designed to prevent losses, even though significant losses do occur. Surety companies accept a tremendous amount of construction risk and receive a small amount of bond premium in return (usually 0.5 percent to 3 percent of the contract price). This model demands that a surety bond underwriter use a thorough analysis process to prequalify a contractor's financial strength and work experience.

**The Underwriting Process**

To prequalify a contractor, an underwriter must use current and historical data to forecast future results. An underwriter will look at a contractor's historical financial success, balance sheet composition, length of time in business, prior work experience, management team and character references. An underwriter will want to review the contractor's personal and business financial statements, as well as obtain references from the contractor's banker, suppliers and previously completed project partners.

An underwriter typically focuses on working capital and net worth to determine if the contractor can manage short-term assets and cash flow in a way that satisfies its future debt while also building a net worth reserve in case of future problems. If a contractor manages working capital successfully, net worth will increase over time, allowing the contractor to grow operations and generate future profits.

Personal indemnity also plays a significant role in the underwriting process, as it can offer additional reserves during difficult times. The personal financial statement of the construction company's owner may provide further proof of past financial successes, as well as insight into the owner's risk tolerance.

Reviewing credit reports and speaking with a contractor's banker, materials suppliers and the owners of previously completed projects will highlight the contractor's character and help the underwriter determine a contractor's borrowing power and past work experience. With the surety company absorbing such a high level of construction risk, it's extremely important for the contractor to show its underwriter that the contractor will stand behind its work and correct any issues that arise.

Being thorough is essential to underwriting. It would be a disservice to the contractor and the project's subcontractors, suppliers and owners if an underwriter were less than thorough. When the contractor supplies a project owner with a surety bond, it is not a meaningless piece of paper. A surety bond from a reputable company means the contractor is a good risk and the project owner's money is protected. Contractors that utilize professional surety agents and surety underwriters as trusted consultants will stand out from the rest as successful, profitable and trustworthy. CE

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# Questions to Ask When Choosing a Surety Bond Producer

BY MARTHA L. PERKINS

Most people would not entrust their rights, assets and health to someone about whom they knew nothing. In today's complex and competitive world, "doing your homework" is essential to ensuring that professional relationships will produce beneficial results for the company. In fact, developing the right relationships often makes the difference between a company's success or failure.

Performing due diligence is particularly important when searching for a surety bond producer. For prime contractors and subcontractors looking to participate in public and private construction marketplaces, a successful relationship with a knowledgeable surety bond producer is crucial. Surety bonds are similar to a credit arrangement, and access to surety credit is limited to contractors and subcontractors that can successfully demonstrate the ability to meet the underwriting criteria of sureties.

Finding the right bond producer is beneficial to a construction firm's growth and development, not only for surety credit extended, but also for advice on technical and financial matters impacting the business. The wrong fit could mean the company is not in the best position to take advantage of emerging business opportunities. Look for professional surety bond producers who offer business relationships built on trust, honesty and frequent communication.

**The Role of a Bond Producer**
Bond producers are business professionals who specialize in providing insurance and surety products to contractors, subcontractors and other project participants. Some bond producers may only sell surety bonds; others may sell both insurance policies and surety bonds. They have a broad knowledge of the surety marketplace

for construction companies, which have to plan for and manage project risks appropriately.

Unlike producers focused on insurance markets, bond producers have particular insight into the business strategies and underwriting differences among sureties and will act in many critical roles—guide, educator, adviser and matchmaker—to position a contractor to meet the underwriting requirements for surety credit.

It is important to note that bond producers must be licensed by the state in which they do business to provide insurance and surety products. To obtain a license, bond producers typically must complete pre-license coursework requirements and pass a written examination and a background check. Bond producers must then meet annual or biannual continuing education requirements to ensure they stay up to date on issues about their services, products and businesses, as well as to maintain their licenses. Find a producer in the National Association of Surety Bond Producers (NASBP) membership directory at *www.nasbp.org.*

As licensed individuals, bond producers are subject to control by state insurance departments, which regulate their activities and will act on grievances. State insurance departments often list grievance procedures and other relevant information on their websites. A list of state insurance departments is available on the website for the National Association of Insurance Commissioners at *www.naic.org/state_web_map.htm.*

**Choosing a Bond Producer**

Following are sample questions to ask or points to consider when assessing whether a particular bond producer might be a good fit for the company's needs.

- Is the producer licensed in the company's jurisdiction and that of the project?
- What is the bond producer's industry standing? Does he or she have a reputation for integrity and respect?
- What percentage of his or her overall business is construction clients?
- Does he or she have knowledge of construction contracts and subcontracts?
- Does he or she have an understanding of the construction industry and the construction process, particularly the management and administration of construction contracts?
- Does he or she possess knowledge of construction accounting procedures, especially an ability to analyze financial statements, work-in-progress and cash flow?
- For small contractors, does the producer focus on and serve the needs of small contractors?
- With how many sureties does the producer work?
- Is the producer specifically authorized to issue bonds on behalf of sureties?
- Has the producer developed solid relationships with surety underwriters?
- Has the producer developed solid relationships with other professional service providers, such as attorneys, CPAs and lenders?
- How aware is the producer of local, regional and national construction markets?
- How active is the producer in local or national construction associations, such as the American Subcontractors Association, Associated Builders and Contractors, or Associated General Contractors of America, and in local or national surety industry associations, such as NASBP?
- Can the producer demonstrate a commitment to maintain frequent client contact through newsletters, jobsite visits or client office visits?
- What other services does the producer provide to help clients with their business needs?

The success and reputation of a business is too precious to entrust to just anyone. Find a bond producer who offers the skills, experience and resources to meet the company's needs and who is interested in building a long-term relationship. Asking the right questions is an essential step to finding the right bond producer for safeguarding a firm's reputation and credit. CE

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# Joint Sureties for Larger Projects

BY DAVID J. ROTH

Black's Law Dictionary defines joint sureties as "two or more sureties to the same obligation." Drilling down further, the definition can be divided into two categories: co-surety, defined as "two or more sureties being named on a bond," and shared surety, defined as "two or more sureties sharing an account." In a shared surety situation, only one surety will be named on each bond, with multiple sureties taking turns writing various, independent bonds supporting separate contracts for the same client.


Today, most joint surety arrangements supporting the bond needs of construction companies are of a co-surety nature. Additionally, these agreements almost always are across the full spectrum of the contractor's bond program. Shared surety often is more aligned with commercial surety bond programs.

Several factors continue to lead contractors and their sureties to co-surety arrangements. Traditionally, multiple sureties on a bond program can provide the contractor with the necessary capacity that they perhaps could not attain with only one surety supporting their bond program. The introduction of an additional surety may be due to the contract price on a single large bond, but over time, ongoing co-surety arrangements usually are tied to the overall aggregate backlog.

The need for additional surety capacity on single projects may be driven by the trend of mega-projects, as the number of global projects exceeding $800 million has more than doubled in the past five years, according to data from the Construction Intelligence Center.

From the perspective of surety markets, partnering with additional sureties can facilitate the diffusion of risk. The key logistics of the co-surety relationship are defined by a co-surety agreement executed among the multiple sureties. In each agreement, one of the sureties is named as the lead surety. The lead surety is on point for any claims handling, but each surety still otherwise individually administers the bond program: underwriting the contractor's financials, reviewing each bond request independently, billing its own premium and completing other program management responsibilities. In recent years, perhaps as an offset to the advancement of larger construction projects, all of the major surety carriers have dramatically increased capacity levels for single project support, as well as for overall aggregate bond programs.

Because of a recent history of highly profitable experience for sureties, new players have emerged and brought additional capacity to the market. As a result, more than adequate surety capacity continues for contractors with strong balance sheets. For some businesses, their sole surety continues to offer unprecedented aggregate support due to the credit quality of the contractor.

It is important to note that the need for a co-surety is not exclusively based on the need for a "giant" bond or backlog. This simply may be a reflection of the surety carrier's comfort with the contractor's bond program needs in relation to its current financial condition.

Regardless of the reasons for establishing a co-surety or shared surety relationship, the contractor should work with its surety broker to find a surety partner that is the best fit for its business. The process of introducing a co-surety partner to a bond program is the same as introducing the contractor to a new surety; however, the current surety or sureties should be included in the process.

Even with the recent success of the surety marketplace and new capacity, this industry remains highly consolidated. A select few sureties have the appetite and capacity to support the largest global contractors with significant backlogs and the ability to extend meaningful levels of support to mega-projects. These companies are frequent partners and act as co-sureties on multiple accounts, so the transition to or addition of a co-surety relationship should run smoothly.

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# To Add a Co-Surety or Not

BY STEVEN SCHMIDT

The decision to add a co-surety to a company's bonding program is never an easy one, nor is it usually straightforward. It is important to consider capacities, loyalty, personalities and even feelings. The marketplace saw a lot of co-surety activity from 2003 through 2007, as contractors were growing in volume and overall capacity in the surety marketplace was limited.

> *"Having a second surety already on the bond program may put the contractor in a stronger position than having a surety in the traditional 'backup' role.*

Today, substantial capacity exists in the surety market and many contractors are beginning to revisit volume levels they enjoyed at their peaks several years ago. Many of the existing sureties have increased their capacity to handle accounts, and a handful of new sureties have entered the large end of the surety marketplace. The reasons for adding a co-surety today are different from those of seven or eight years ago.

Contractors rely heavily on their professional brokers to help them navigate the world of surety. There are some good reasons to add a co-surety to a surety program, and there are arguments not to add a co-surety or additional co-surety. For some customers, this is a particularly complicated decision because some programs have many co-surety partners.

The primary reason to add a surety is if the firm's existing surety does not have the capacity to handle its surety needs today or at some point in the near future. Ideally, the company and its broker have been in touch with its surety and concur that additional capacity might be required to support business strategies.

Two important considerations are: What surety should be added, and how much of the program will it handle? A new surety partner needs to understand the business and be comfortable with its business plan. It also is helpful if the sureties get along with each other. Should the new arrangement be split evenly, or should the existing surety retain a bigger piece given its experience and loyalty? If there are more than two sureties, who gets how much of the program, and what is the reason for splitting it this way? The contractor's broker may help work through some of these decisions.

Risk management is another reason large contractors consider adding sureties to their programs. Does an additional surety bring some unique expertise or experience? What happens to the contractor's ability to secure and execute work if its current surety experiences financial issues?

Some bond forms stipulate that bonds will have to be replaced if the surety's financial ratings fall below a certain level. It might be difficult to replace a bond on an ongoing project, so having two or more sureties on the bond might make this need to replace a bond highly unlikely.

Along similar lines, what happens to the contractor if a dispute arises with its surety company? Having a second surety already on the bond program may put the contractor in a stronger position than having a surety in the traditional "backup" role. Presumably, the remaining surety could pick up the slack while a new surety is brought into the mix should one of the sureties decide to exit.

Keep in mind, a co-surety program may not always be the right fit. Is adding a new surety going to cause hard feelings with the firm's existing surety partner? If so, can they get over it? Adding a surety involves a new indemnity agreement. It also introduces more complexities and more underwriters—and potentially more questions and more surety meetings. Should they be joint meetings with both or all sureties, or separate meetings with each? A broker can assist with sending requested information to each surety, which then have a chance to review the account and project information and ask questions.

A hint of competition among the sureties may be a good thing for the contractor. Which surety responds the quickest? Which asks the best questions? Which asks the least informed questions? Which demonstrates the most knowledge about the contractor's business?

The additional capacity and stability provided by adding a second (or more) surety has its benefits. Whether these are worth the additional indemnity agreements, meetings and questions is up to the contractor and its broker to decide.

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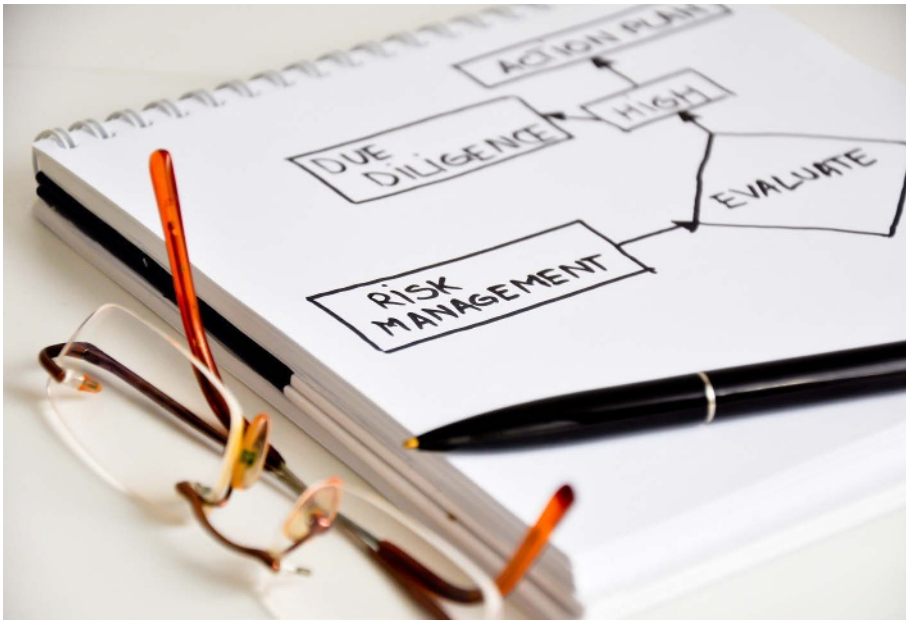
# Individual Sureties: Navigating the Risks

BY CATHY DONAHUE

The school year begins, but cinderblocks sit where a new classroom should be. Ground is broken for a new church, but after it's framed, work comes to a standstill. The surety bonds written by individual sureties on the projects should have covered their completion costs, but they didn't. Then there are the contractors whose bids were rejected because they submitted unacceptable individual surety bonds, but were unable to get back the premiums they paid for the bonds that were never used. Do these scenarios sound familiar?

Even for the most prepared and experienced contractors, there's always the possibility that something could go terribly wrong on a construction project. Surety bonds are designed to respond to these unexpected obstacles. Almost all surety bonds are issued by insurance companies licensed to write these guarantees. The federal government allows contractors to provide bonds backed by certain assets in lieu of corporate surety bonds, and those bonds are written by individual sureties.




While bonds written by individual sureties may offer contractors an alternative to corporate surety providers, these bonds also may pose a risk for the contractor and for the obligee. Recent media reports have detailed the potential risks of obtaining bonds from individual surety providers, which in those cases were not as financially solid as they purported to be.

**Vetting Individual Sureties**

Individual sureties issuing surety bonds in the United States are required to be licensed pursuant to applicable state laws and regulations, unless issuing bonds to the federal government pursuant to the Federal Acquisition Regulations (FAR). The FAR stipulates that individual sureties meet certain requirements, but the requirements are not as rigorous as they could be,

> "Individual sureties, and the assets they claim to pledge to back the bonds, aren't rated by any agencies.

and enforcement often is challenging due to limited federal resources to properly vet individual sureties and the assets that are purported to back their bonds.

Contractors can review financial ratings provided by independent rating agencies to help them determine a corporate surety's ability to respond to a contractor default. But, individual sureties aren't rated by any rating agencies because they are individuals, and the assets they claim to pledge to back the bonds are not rated either. Therefore, it is hard to know if they have sufficient assets to respond when needed.

Because a surety bond is intended to provide an obligee with a certain level of assurance that the bonded obligation will be performed in accordance with its terms, it is critical for the assets to support that guarantee. A corporate surety bond is backed by the assets of a corporate surety insurer. However, when a firm buys an individual surety bond, it is buying a bond backed by that individual's alleged property or assets. Unfortunately, it's often not until a default occurs in connection with the underlying bonded contract that the assets supporting the bond may be found to be inadequate. The risk generally transpires because the individual surety may put up collateral that is overvalued, illiquid, speculative or pledged to multiple projects so it can't be used by the surety to perform its obligations.

Using an individual surety may pose more risks than many contractors or obligees are willing to take on. Ensuring that the surety has the qualifications and financial strength to secure a project takes some research; following are some key characteristics to look for.

**Experience and Infrastructure**

The successful completion of a construction project requires experience and expertise in business, finance, construction trends and more. Most corporate sureties have underwriting and claim departments in place to help prequalify and evaluate contractors' ability to complete the job, identify and head off issues, and respond quickly if they occur. Individual sureties generally don't have the same level of experience and infrastructure in place.

Because even the most experienced construction companies can run into unforeseen challenges, it's important that claims personnel are able to work closely with the contractor and obligee in an effort to address any issues that arise. Accordingly, contractors should ask if the surety has experienced underwriting and claim departments.

**Strong Financial Backing**

A contractor working with a corporate surety provider should look for one that has received high financial ratings from independent rating agencies. Even if a contractor determines that an individual surety bond is acceptable, it should verify that the obligee will accept that bond and also verify the assets backing the bond.

Additionally, the contractor should confirm that the purported assets are actually owned by the individual surety, are accurately valued, easily liquidated, and are not otherwise pledged or encumbered. It's also prudent to ensure that the terms and conditions of the bond do not provide illusory coverage.

All business relationships involve risks, and individual sureties are no exception. If a firm is considering obtaining an individual surety bond, take a close look at the applicable laws and regulations to ensure that the individual surety is entitled to provide this service. Then, carefully review the quality of the individual's operations and assets. Doing research now could prevent unwelcome—and costly—surprises later. CE

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# Claims Management: A Problem-Solving Approach

BY AARON BLANKENSHIP

Contractors are skilled problem-solvers with the knowledge and expertise required to successfully complete today's complex construction projects. Experienced contractors understand that early identification and evaluation of disputes and timely resolution of subcontractor and supplier claims are critical components of efficient and cost-effective project management. Disputes cost money and divert critical resources. Contractors that leverage their existing skills in identifying and mitigating risks, and that take steps to proactively and thoughtfully manage claims, will minimize their claim-related costs and optimize claim outcomes.

Contractors take different approaches to problem-solving, but the process involves common elements: investigation and evaluation; plan formulation; identification, allocation and management of resources; and periodic reassessment and resolution.

**Investigate and Evaluate the Claim's Strengths and Weaknesses**
Cost-effective claim management requires an early assessment of the strengths and weaknesses of the parties' positions. Once the contractor has verified compliance with any claim notice requirements, its attention should be focused on a timely analysis of the merits of the claim.

An accurate assessment requires consideration of all available and relevant facts. All claim-related material should be gathered and organized so that it reveals the claim's underlying factual narrative, and explains the "who, what, when, where, why and how" of the dispute. This will enable the contractor to quickly identify any holes in the documentation and take steps to obtain any supplemental information that it might require.

The contractor should incorporate these facts into a written

explanation of why its position should prevail. The contractor should be able to present a coherent narrative that supports a meritorious request for relief or a legally supported basis for a claim denial. If the contractor cannot craft a persuasive narrative, this may indicate that the claim is problematic and that additional investigation and consideration is required.

At this stage, the contractor also should try to anticipate its opponent's narrative. In doing so, the contractor should ask:

- What will the other party contend?
- Is the other party's interpretation reasonable?
- If the other party's position has merit, what impact does it have on the contractor's position?

**Formulate a Claim Resolution Plan**

Once the contractor collects, organizes and evaluates the claim information, and determines what result it wishes to achieve, it should formulate a claim resolution plan. The plan should take into consideration the relevant facts and legal theories, any applicable contract dispute resolution provisions and any business realities that might affect claim prosecution or defense. As early as possible in the claim process, the contractor should also identify plan implementation costs.

As part of this process, the contractor may wish to seek assistance from both in-house personnel and outside advisers. Project personnel will be the closest to the situation and may provide the best information on how the plan may impact job completion. Home office personnel will be better situated to incorporate customer, marketplace and overall business concerns into the plan. Outside advisors can provide a more neutral assessment of the claim and its legal and technical aspects.

If the claim involves a surety bond, the contractor should make its surety aware of its claim resolution plan early in the claim process. The importance of engaging agents, brokers and sureties in this process cannot be overstated. The surety is a valuable resource for contractors seeking to develop workable solutions that will protect their interests and their assets. Early surety involvement also ensures that any surety-specific issues or defenses are given appropriate and timely consideration. Most surety companies have sophisticated claim departments that are staffed by knowledgeable claim professionals who can share pertinent technical information, legal theories and claim analysis.

**Identify, Allocate and Manage Required Resources**

The contractor should designate a claim "manager" who is capable of coordinating the implementation of the claim resolution plan and who can provide consistent leadership.

Many contractors find that their claim plans require the retention of attorneys or consultants. In these situations, the contractor's surety is a valuable resource. Most sureties have years of experience with multiple attorneys, accountants and technical experts. The surety's claim department can assist the contractor in identifying and evaluating potential claim resources.

Cost management is an integral part of claim management. Just as contractors use job cost accounting procedures to manage their construction costs, they should identify and monitor claim-related costs. Consultant and attorney budgets and retention agreements can help the contractor manage these costs. In addition, when paying claim-related invoices, the use of claim expense cost codes can help the contractor maintain accurate cost accounting information.

**Reassess and Resolve**

As claim prosecution or defense proceeds, contractors may find that new or additional facts are discovered that alter their views of the claim. Pertinent case law may be discovered, or the contractor may determine that its initial claim resolution plan did not adequately anticipate costs. Business concerns that impact the contractor's initial claim evaluation may develop.

It is important for the contractor to reassess its position frequently during the claim process. Successful construction contractors are expert problem-solvers, and they align skill sets with tasks every day. Contractors that effectively leverage their existing expertise to manage construction claims will minimize their claim costs and maximize their claim recoveries.

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# Surety and Construction Industries Work Together On Critical Legislative Issues

BY STEPHANIE ROBICHAUX AND DANIEL WANKE

Most state legislatures have been focusing on finalizing fiscal 2015 budgets this year; however, there were some important pieces of legislation impacting construction and surety, as well as some major victories.

With budgets continuing to be tight, public entities in the United States are looking for ways to fund much-needed infrastructure projects, and public-private partnerships (P3s) are becoming increasingly popular. State-level interest in P3s remains strong as a way to get infrastructure projects completed sooner than would otherwise be possible without private investment. More than a dozen states introduced P3 legislation this year. Indiana expanded its P3 law to allow P3 agreements for local governments, and Ohio amended its existing P3 law for transportation projects to require, among other things, that the P3 agreement include performance and payment bonds.

At the federal level, Congress and federal agencies have been assessing the use of P3s. The House Transportation and Infrastructure Committee released a report on its study of P3s for transportation, and the U.S. Treasury Department and the U.S. Department of Transportation recently held a summit on innovative project financing. Further, the Federal Highway Administration (FHWA) has issued a final model contract for toll concessions under P3s as directed in the Moving Ahead for Progress in the 21st Century Act (MAP-21). The Surety & Fidelity Association of America (SFAA) submitted comments on the draft model contract and recommended performance and payment security requirements for the construction portion of the P3 project. The model contract does not address bonding, but the FHWA stated it will develop an addendum that addresses secondary issues for P3s, including performance security requirements.

In addition to project financing solutions, a few states looked at increasing their bond thresholds in 2014. In Oklahoma, S.B. 1582 would have increased the threshold for public construction contracts from $50,000 to $150,000. This would have negatively impacted both taxpayers and the subcontractors that rely on the payment bond. SFAA worked with the American Insurance Association (AIA) to defeat the bill.

SFAA also continued its work on individual sureties. In Maryland, the bill to extend the law permitting individual sureties to pledge assets to bond contractors on state public works projects was not extended. SFAA has worked closely with the National Association of Surety Bond Producers (NASBP) and other construction associations over the years to defeat various attempts to expand the law. (For risks association with individual sureties, see the article on page 88). The Maryland Insurance Administration conducted a comprehensive study of sureties and concluded that there had been significant fraud with individual sureties and that the state's individual surety law should be allowed to sunset this year, which it did.

States continued to seek changes to retainage requirements in 2014. In New York, SFAA, AIA and the local chapter of Associated General Contractors defeated S.B. 980/A.B. 725. The bills would have prohibited withholding retainage on any payment due to a material supplier for materials that have been delivered and accepted on a private construction project, and would have prohibited including such payments in retainage for public projects. In Missouri, S.B. 529 revised a law that capped retainage at not more than 5 percent of the contract or subcontract, except in certain cases when up to 10 percent could be withheld. The new law, supported by the surety and construction industries, caps retainage at not more than 5 percent of the contract or subcontract when a bond is required under the little Miller Act. Retainage may be up to 10 percent of the contract or subcontract for contracts under this threshold.

At the federal level, the surety and construction industries have formed the Construction Coalition to promote legislation containing procurement reforms that the entire construction industry supports. Many of the reforms increase small business participation on federal projects at no additional cost to the federal government. The coalition's legislation includes SFAA's key federal issues, which are to:

- amend Title 41 to exempt the Miller Act from indexing for inflation;
- assure that federal P3 projects are bonded;
- increase the Small Business Association (SBA) bond guarantee to sureties in the Preferred Surety Program; and
- require individual sureties to post the kinds of collateral that contractors must post to secure their obligations.

The federal Construction Coalition bill also contains provisions to prohibit reverse auctions and to streamline the two-step design-build process so it is not prohibitively expensive for potential bidders. These latter two construction provisions, along with the individual surety and SBA Bond Guarantee Program provisions, were passed by the U.S. House in its version of the National Defense Authorization Act (the annual defense policy bill). SFAA, its members and other coalition members kicked off work in the Senate during SFAA's Congressional Action Day in May. Organizations joining SFAA on the Construction Coalition are:

- American Council of Engineering Companies;
- American Institute of Architects;
- American Subcontractors Association;
- Associated General Contractors of America;
- Council on Federal Procurement of Architectural & Engineering Services;
- Design-Build Institute of America;
- Independent Electrical Contractors Association;
- National Association of Surety Bond Producers;
- National Electrical Contractors Association; and
- Women Construction Owners and Executives, U.S.A.

P3s, bond thresholds, retainage and individual sureties have been critical legislative issues for the surety and construction industries in 2014. SFAA expects that they will continue to be hot topics in 2015. P3 legislation should continue to be introduced as states seek project financing solutions. P3s have been discussed as one tool in the toolbox for procurement, and the federal government is likely to use them more. The Association for the Improvement of American Infrastructure has issued a Best Practices Guide to P3s that includes performance and payment bonds on the design-build and construction portion of these projects. This best practice will be considered by Congress and state legislatures as they address this critical issue.

Tight budgets and concerns regarding access to contracts likely will bring proposed increases to state bond thresholds. SFAA and NASBP will be continuing their work in the states and will seek federal procurement reform along with other members of the Construction Coalition. As 2014 winds down, the construction and surety industries are working together to address these critical legislative issues in 2015.

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# Why Subcontractors Fail And What to Do About It

BY SCOTT WOLFE JR.

Subcontractor default is neither understated nor under-reported. Everyone in the industry is familiar with it and the consequences of the likely, yet always surprising, situation when a subcontractor defaults on a project.

Starting in 2008, the construction economy started to tank, and the industry experienced a wide number of subcontractor defaults. Now that the economy is recovering, it's natural to think that defaults will be less common. The unfortunate fact is that subcontractor default is three times more likely in this recovering period than it ever was in the economic downturn.

Therefore, it is more important than ever to review why subcontractors fail, and what everyone else should be doing about such failures.

**Why Do Subcontractors Fail?**
There are options for companies to mitigate the risks of subcontractor failures. Understanding why subcontractors fail can help fix the problem at the source, as opposed to focusing on too many failure symptoms.

- **Cash flow.** The most basic explanation for subcontractor failure is that the business runs out of cash. There are many reasons for this; most notably, subcontractors often are expected to float the project costs. They pay for all materials on terms, pay all laborers weekly, give up to 10 percent of their revenue to retainage withholdings, and then wait for 30, 45, 60 days, or longer, after fronting the cash to get paid by the general contractor or owner. These are unrealistic expectations for any company that is not flush with capital.
- **Lack of access to capital.** Because subcontracting is such a risky and cash-hungry business, it's really difficult for businesses to get capital access from traditional banking sources. This is especially true in the recovering economy, where lenders are more reluctant to fund construction investments than ever. The result is that subcontractors lack any access to affordable capital. When they are pushed to get funding, they pay higher rates, putting them into a vicious cycle of interest payments and cash needs.
- **Tough work.** Selling washing machines is simple. A buyer gives the seller money, and the seller gives the buyer a washing machine. The machine may have a flaw, but identifying the flaw and fixing it is pretty simple. However, in the subcontracting business, work is layered upon the work of many other parties; the work itself must meet a subjective-type approval; and there are many things that can go wrong on the jobsite that puts the subcontractor in a practical or legal crosshairs. This all feeds into the aforementioned problems, as this is yet another cause for heightened cash needs.

**Three Ways to Handle Subcontractor Failure**
The failure of a subcontractor can be sudden and can cause vast problems. Therefore, the question is whether anything can be done about it. Following are the top three ways to protect against subcontractor failure.

1. **Lien rights.** Though this doesn't apply to firms at the top of the chain (general contractors, owners and lenders), it is still the number one protection measure because of how enormously effective it is for all of the other affected parties. In fact, it is even effective for the defaulting

subcontractor, as it can put it in the best position to claw its way out of a bankruptcy proceedings. Lien rights protect a company's right to get paid for work, and more importantly, prevent companies from being placed into the back of a payment line. A subcontractor in the front of the payment line avoids cash problems, and is insulated from others defaulting on the project.

2. **Surety bonds.** Subcontractors can obtain performance bonds and payment bonds, and it's common for general contractors, owners and lenders to require some subcontractors to acquire these bonds. When a subcontractor has these bonds, a default is less burdensome because the surety bond will compensate the affected parties for the losses.
3. **Prequalification.** Top-of-the-chain parties often use prequalification to assess the likelihood of failure by a lower-tiered party (e.g., a subcontractor). Lower-tiered parties also can use prequalification to assess the problems that might arise by higher-tiered parties.

Everyone is affected by default and should do preliminary analysis to avoid it. Examining the ability of a subcontractor to deal with expected cash flow challenges is a necessary evil in today's construction economy. Also, it serves everyone well to make sure the subcontractor is taking measures to protect lien rights. If not, the subcontractor is going to be in the back of the payment line, and the result is a heightened default risk.

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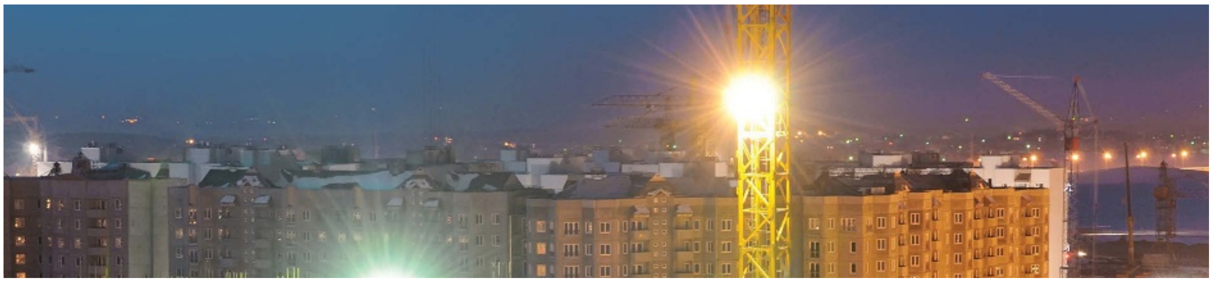

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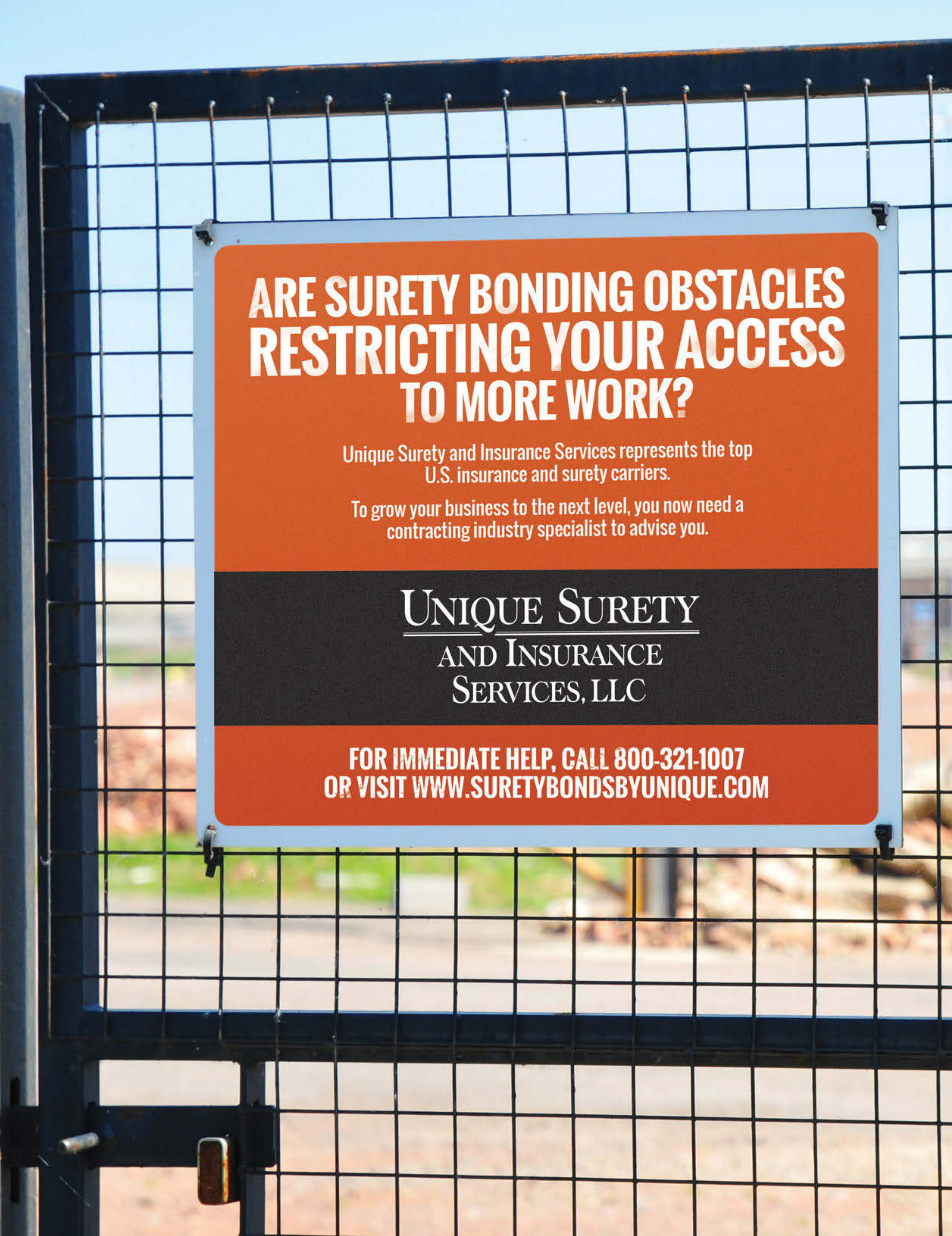
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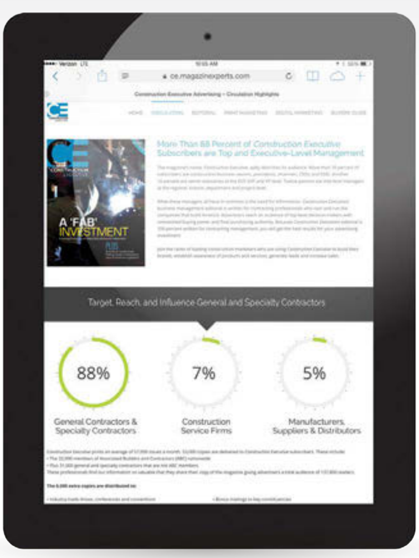


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