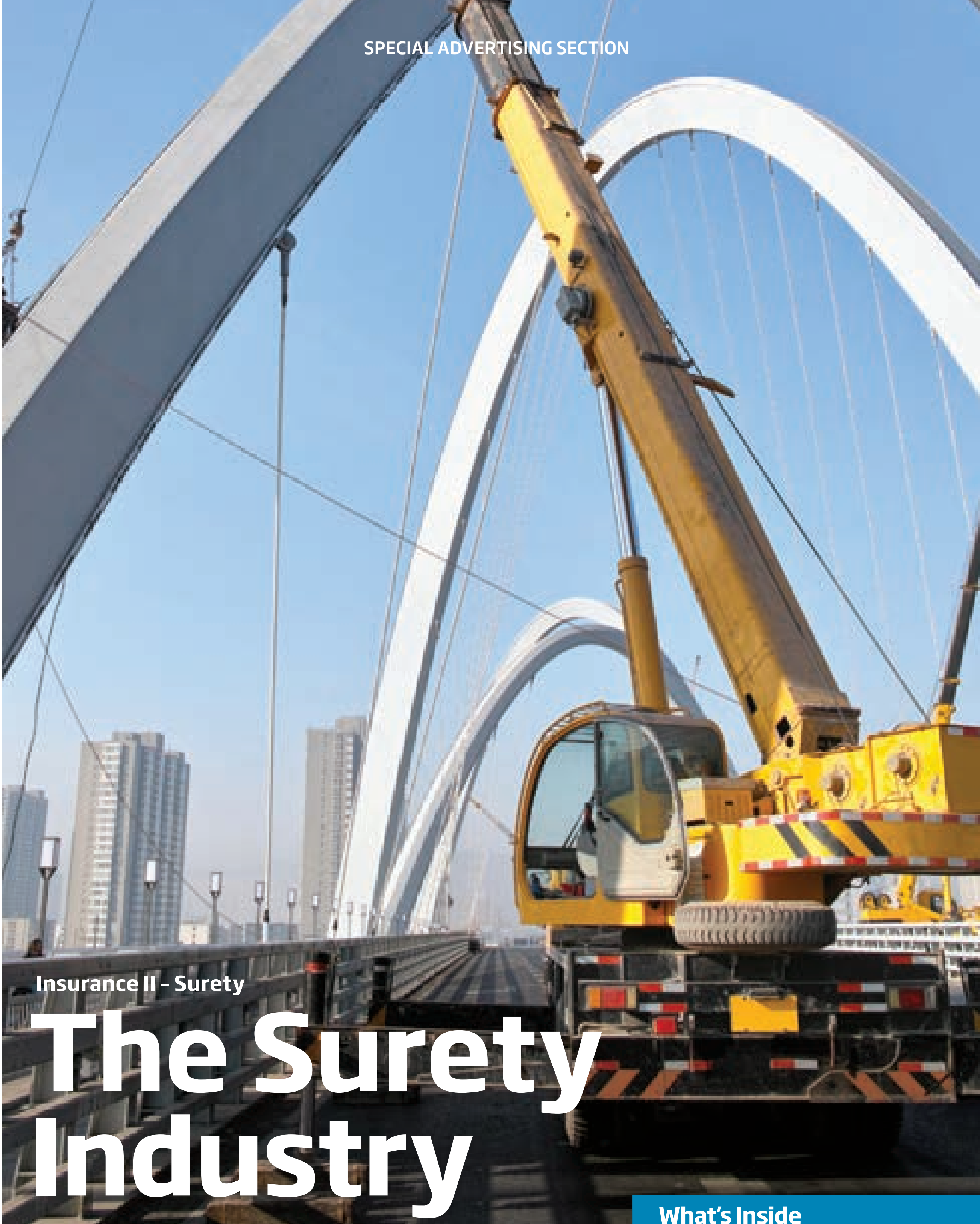


PHOTO © SHIJIANYING | DREAMSTIME.COM

Insurance II - Surety

The Surety Industry

Recent Challenges and Successes and Looking Ahead

What's Inside

Surety Market Overview

BY STEPHANIE MATTHEWS, Communications Manager at The Surety & Fidelity Association of America

As the United States recovers from the economic downturn, construction opportunities lag behind, due mostly to the lack of public spending. The nation's unemployment rate was 5.5 percent in May, down from 6.3 percent in May 2014, according to the U.S. Department of Labor. The construction industry is slower to recover, though, with an unemployment rate of 6.7 percent in May, an improvement from 8.6 percent at the same time last year. Generally, surety leaders are optimistic about the future, but are realistic about losses in the short term.

"There is ample evidence that the size of surety losses is increasing and given the historical data documenting increased contractor failure rates during economic recovery, the next few years could be very costly for the surety industry. While increased loss activity could adversely affect isolated surety markets, I don't foresee overall surety capacity decreasing because of losses," says Bill Waters, vice president of contract surety for CNA Surety.

SMALL

There is adequate capacity for contractors in this market, despite this segment being hit the hardest by the recession. "The number of underwriting companies in this segment, abundant capacity, and desire for premium has resulted in ease of underwriting in the small market. In some instances credit reports and tax returns are all that are needed to support small bond requirements. Bond penalties tend to be small and project durations short so portfolio style underwriting is sometimes applied," says John Gambino, senior vice president of Construction Services Group for Alliant Insurance Services, Inc.

"Rates are stable and competitive. Caution is warranted, however, as to how the prior recession has impacted these firms as capital bases are limited and work has been hard to come by until recently," says Bob Staples, senior vice president of surety for Allied World National Assurance Company.

MIDDLE

The middle market remains highly competitive, and capacity is plentiful. "Surety availability is plentiful for properly capitalized and well managed companies. Sureties are being challenged to remain disciplined as middle market contractors are showing signs of rapid growth," says Josh Penwell, vice president of contract underwriting for Merchants Bonding Company.

"We feel that this market continues to be competitive, but there is indication that underwriting terms and conditions have stabilized somewhat, which may be a result of loss activity in the sector," says Gregg Lyon, second vice president and strategic officer of Construction Services for Travelers Bond & Specialty Insurance.

Generally, surety leaders are optimistic about the future, but are realistic about losses in the short term.

LARGE

Fewer sureties occupy this space in the market, but there still is a good amount of capacity for contractors with solid business structures. "There is sufficient availability and reasonable underwriting standards in this market," says Henry W. Nozko, Jr., president of ACSTAR Insurance Company.

"Once a contractor is in this market segment, it is not unusual for a contractor's management structure to include both a CFO and often a general counsel. The surety expects sophisticated internal information, cash flow projections, when needed, and the contractors to regularly utilize the reports their systems generate to manage their business," says Susan Hecker, executive vice president and national director of contract surety for Arthur J. Gallagher & Co. in San Francisco, CA, and president of the National Association of Surety Bond Producers.

MEGA

Only a handful of sureties are available to write at this level, and co-surety arrangements are not unusual. "This segment has seen the biggest impact of new surety capacity. Surety industry results have been strong for many years and new entrants are seeking to gain market share. More established sureties have extended capacity to strong contractors who see the value of long-term relationships," says Michael Bond, executive vice president and head of surety for Zurich.

According to Nate Zangerle, specialty chief underwriting officer for Liberty Mutual Surety, "Projects in the mega space continue to ramp even higher in both size and complexity. The credit profile of firms in this segment remains favorable overall. Those contractors with the highest credit quality will continue to enjoy strong surety support and sufficient capacity in pursuit of increased work opportunities."

Contractor Failure & Value of Surety Bonds

Surety industry leaders say that they have seen an increase in contractor failure over the last year and expect that trend to continue, at least for the short term. "We saw a significant amount of small contractor failures early in the recession, but lately we've seen larger contractors suffering. The

Surety Market Overview continued

common story line for many is that they had the resources to survive the downturn but made ill advised decisions to maintain their revenue base rather than right sizing their operations. Most common mistakes were expanding into new territories, not cutting overhead drastically enough and teaming with unproven contractors," says CNA's Waters.

David Hewett, president of surety for XL Catlin, says that contractor failures are "very typical at this point in a recovery cycle. With the increase in construction costs related to materials and fuel, profit margins may grow even thinner before showing any improvement. This is the tipping point for many contractors, straining their financials and leading to additional failures. Fortunately, some contractors are seeing a slight increase in their profit margins but it's not a substantial increase yet. It's still too early in the recovery cycle to see significant improvements," he says.

Surety leaders remind owners and contractors that the losses resulting from these failures are preventable. "Performance and payment bonds provide 100 percent risk transfer for an obligee, whether it is a private owner or general contractor. A surety prequalifies the contractor and/or subcontractor if the bond is issued by a rated surety, and surety claims handling can assist in getting a project back on track or facilitate the completion of the project when things go wrong," says Geoff Delisio, senior vice president of surety for Berkshire Hathaway Specialty Insurance.

"These protections are even more critical as jobs become larger, as well as riskier, and as contractors bid on work with low profit margins. Sureties play a valuable role in the prequalification process, underwriting their contractor customers and components of their work programs to help ensure successful delivery and completion," says Rick Ciullo, chief operating officer of Chubb Surety. "The investigation process is backed by the assets and creditworthiness of the surety company's guarantee. It is a time-tested vehicle for evaluation and transfer of risk in an economical fashion," says Travelers' Lyon.

Though not required by law to use bonds, even private owners and lenders recognize their value. "Use of bonds on private work is more prevalent as a result of more project lenders requiring bonds," says ACSTAR's Nozko. He and other surety leaders in certain areas of the country are seeing an increased use of bonds on private projects. "Use of surety bonds has increased on larger multi-family residential and assisted living facilities," says Alliant's Gambino. "The bonding requirement on private developments typically is driven by the source of project funding."

Those owners that are not requiring surety bonds on their projects, should be, says Fran McGrath, contract chief underwriting officer for Liberty Mutual Surety. "With a gradual recovering construction market following a prolonged period of leveraged balance sheets coupled with tight profit margins and cash flow, private owners and their financing partners should strongly consider requiring bonding for their projects," he says.

"Performance and payment bonding will help ensure that project owners, architects, lenders, and end users will be satisfied. It will save substantial overhead expenses in the form of lower legal fees, less management time spent on non-productive issues, and less time spent sending unnecessary correspondence," says Merchants' Penwell.

Surety leaders expect that losses likely will increase in both severity and frequency, at least in the short term.

Looking Ahead

Surety leaders expect that losses likely will increase in both severity and frequency, at least in the short term. Berkshire Hathaway's Delisio says this "will likely be driven by small and mid-size subs/contractors who run into trouble during the upswing in the economy as well as a few larger contractors who had not been able to recover from the downturn in 2007/2008. Overall capacity will not be impacted."

"Many firms refused to downsize their operations, hoping instead that new work would come in time to support their current operational structures. For 2015, projects, both private and public, are more plentiful with better margins available, however, within certain niches, bid lists remain long and margins suppressed," says Allied World's Staples.

Overall, surety industry leaders are optimistic about going into 2016. "The outlook of the surety marketplace remains bright, but somewhat flat with a continued mixed bag of results. Bank credit has become more plentiful, so contractors with restricted cash flow may have more room to continue to over-extend themselves. Contractors with credibility with their sureties will be able to stretch as new opportunities arise. Competition will remain strong in both the construction and surety industries," says Hecker of Arthur J. Gallagher & Co. and NASBP.

"The industry is flush with capital and new entrants are vying for business. Loss activity will impact smaller and less well financed contractors and tighten underwriting standards, so contractors in those areas would be wise to firm up their surety relationships to position themselves for the coming changes," says Zurich's Bond.

XL Catlin's Hewett says, "Coming out of such a prolonged weak market, contractors are moving forward carefully and are hopefully tapping into the risk management expertise and guidance that their sureties can provide."

Stephanie Matthews is the communications manager at The Surety & Fidelity Association of America and can be reached at smatthews@surety.org.

Be certain of one thing: With our surety services, your business will be given every chance to succeed.

We know the construction business is complex. As a Travelers customer, you'll get informed advice to help you deal with it all. With an industry-exclusive Peer Group Analysis and Risk Management tools, we'll help you through the ups and downs of the business. We've been a leader in the surety industry for over 100 years. Find out why. Contact your Travelers agent, or visit travelers.com/bond.

TRAVELERS

It's better under the umbrella®

travelers.com

Executive Viewpoints 2015

What is the key to holding onto your best employees as business picks up and the economy recovers?

RICK CIULLO
Chief Operating Officer
Chubb Surety

A higher salary can be one reason someone might leave an organization, but it is rarely the only reason. Several factors cause top talent to look for new opportunities.

Holding on to your best talent, your A-team, has to start long before someone becomes vulnerable to the advances of your competitors. People stay on teams when:

- They get the mission. They understand, buy into, and are aligned with the team's mission.
- They feel liked and respected; these aren't always the same thing. We may respect skilled craftspeople and managers for what they know and do, but most people also want to feel that they are liked and fit in with their team.
- They have the resources to succeed, the authority to make decisions, and the incentives to be accountable for the outcomes.
- They understand the process for continuous learning, career advancement, and contributing at a higher level.

Those who run businesses have to clarify the company's mission, delegate authority, invest in resources, and create a culture that supports learning, growing, and contributing over a 40-year career. Developing and maintaining top talent is a lot of work and it can be costly, but it's less expensive than running a complex business with a B-team.

MICHAEL BOND
Executive Vice President and Head of Surety
Zurich

At a recent construction industry conference, industry experts stated that the biggest challenge for contractors in the next 10 years is the attraction and retention of top talent. Leading surety executives believe that is the exact same challenge facing the surety industry. Surety is a relationship business, and, as baby boomers retire, those customer relationships and longtime construction industry knowledge will go with them.

The solution for the surety industry is to create a collaborative environment where sureties foster a team atmosphere to attract, service, and retain customers. Meaningful responsibilities need to be delegated to upcoming talent, and baby boomers need to be accountable for training and mentoring those new surety executives. Fair and competitive compensation is part of the picture as well to recognize strong performance and reward customer oriented behaviors.

GEOFF DELISIO
Senior Vice President, Surety
Berkshire Hathaway Specialty Insurance

Having a compelling and thoughtful culture is the key to enduring long term, mutually beneficial relationships with employees. A company needs to clearly define how it chooses to compete in the marketplace and the characteristics it wants associated with its firm. Talented employees demand more than reasonable pay and benefits; they want to be a contributing member of a team. These highly motivated individuals want to be involved with meaningful work that is valued both within and outside the organization. The days of employees being happy with being a "cog in the machine" are long gone. In short, they want to believe in and become invested in the company where they work.

The company must do more than just communicate a culture or post a mission statement on the conference room wall. This is not about placing a pool table in the break room or casual Friday—it's much more intangible and difficult than that. All the actions, policies, and procedures must be consistent with and supportive of the culture. The employee needs to see and feel it every day in all that they do. The key is culture—when there is alignment between the company and the employee on this point, fluctuations in the economy and labor market become background noise.

STEPHEN HANEY
Division President, Surety, and CUO, Global Surety, ACE Group
Chair, SFAA Board of Directors

Holding onto good employees can be challenging at any time, but especially in periods of heavy industry growth. It's important for companies to recognize that investing in their people is a critical factor in retention, and that this is a long term process—one that starts on the first day of employment and continues as the employee grows within the company.

Today's employees don't focus only on a paycheck. Establishing a defined advancement plan early in their employment is critical, as is providing continuous feedback and training to help them achieve their goals. Organizations need to sponsor personal development and educational opportunities, placing an emphasis on building out an employee's skill set. Sureties should also help their employees gain visibility in the industry, and encourage them to become active members of organizations such as SFAA and NASBP. These steps strengthen the workforce, and also help ensure employees feel valued within the organization.

One of the most important ways to underscore an employee's importance to the organization is to enable them. Trust them to do their jobs, and empower them to succeed. Employees who feel both valued and excited about their work and growth will rarely look elsewhere.


WE GET
PEOPLE
ON THE
GROUND
WHERE YOU
NEED THEM.
ZURICH INSURANCE.
FOR THOSE WHO TRULY LOVE THEIR BUSINESS.
zurichna.com/surety
ZURICH®

Executive Viewpoints 2015 continued

SUSAN HECKER
Executive Vice President & National Director of Contract Surety
Arthur J. Gallagher & Co., San Francisco, CA
President, National Association of Surety Bond Producers

Motivating, developing, and retaining high potential talent is one of the biggest issues the surety and construction industries are facing. Fully engaged people are necessary for every business to thrive. The key to holding onto those people identified as high potential talent lies in creating engagement so people remain motivated, work with passion and focus, as well as cross generations to teach or seek counsel. If all you do is give orders, all you end up with is a bunch of order-takers.

Today's employees, especially high performers, want to be challenged and have a voice in creating the strategic roadmap on where the company is headed. They want to be part of something bigger than their day-to-day jobs. In order to create engagement, a strong company culture is necessary, communication must be open and fully transparent, and people need a clear line of sight with vision and clarity. An environment needs to exist where their passion for the business is cultivated and celebrated. Today's leader surrounds him/herself with strong people with differing perspectives and recognizes our businesses are nothing more than the sum of our people. People will stay in an environment where they are compensated fairly, have a voice, and are fully engaged.

What opportunities or challenges does the increased use of P3s bring to the industry?

BOB RANEY
Senior Vice President, Construction Services
Travelers Bond & Specialty Insurance

The increased use of P3s in North America has given us a great opportunity to demonstrate the value of our product and increase the use of bonds on a growing number of projects that otherwise may have gone unbonded. During the past year, we have made significant progress in educating key P3 stakeholders on the broad coverage that surety bonds provide and the substantial limits available in the form of surety bonds versus other forms of performance guarantees. We have also developed a specialized bond form for use in both the U.S. and Canada that provides time certainty for the resolution of a surety claim. This "Expedited Dispute Resolution" style bond form should go a long way in helping contractors reduce or eliminate altogether the need for a liquid demand form of performance guarantee on P3 projects and improve their access and ability to compete in this new and growing market.

NATE ZANGERLE
Chief Underwriting Officer, Specialty Surety
Liberty Mutual Surety

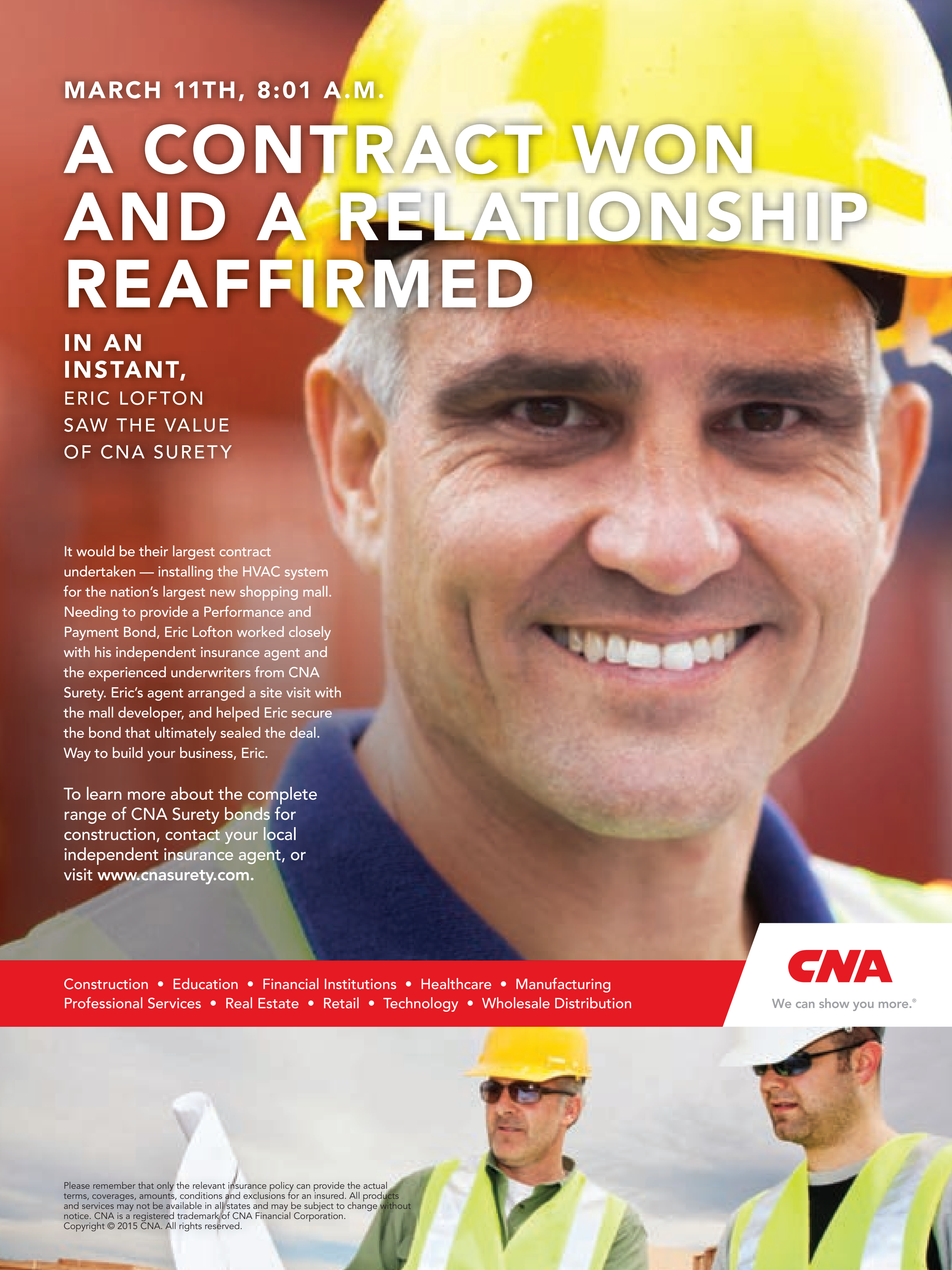
Given the lack of funding and financial strain in many governmental agencies, public-private partnerships (P3s) are becoming more popular as a way to achieve infrastructure policy goals. The increase of P3s in the U.S. poses an excellent opportunity for sophisticated firms that understand that space and have the financial strength to be an infrastructure developer. Unlike Canada, the U.S. does not have a centralized approach regarding best practices and the execution of P3s. The states, through enabling legislation, decide whether or not to allow P3s and how they will be executed. That lack of a centralized approach increases pursuit costs and means that P3 offerings will remain inconsistent in both RFPs and states that execute P3 projects well. Due to the significant investment required to pursue P3s, we will continue to see multinational construction firms enter the U.S. in pursuit of these projects. Any account wishing to pursue this space must decide what type of project best fits its technical knowledge and skill sets, what states have the best enabling legislation for P3s and are committed to the process, and what degree of financial commitment it is willing to make either in tender pursuit costs or as a sponsor.

DAVID HEWETT
President of Surety
XL Catlin

P3s have been a popular method of delivery in many European countries and Canada. To date, 33 U.S. states and one U.S. territory have enacted statutes to enable P3 alternatives for transportation infrastructure. This piqued interest in the U.S. will certainly lead to increased opportunities for the construction industry and, in turn, sureties.

What is significant about P3 projects is that they put a greater emphasis on the entire life cycle of a project because they involve design and construction as well as operation and maintenance. For many contractors, this presents new business opportunities and an additional resource stream and, in turn, it provides opportunities for insurers and sureties to work together to help contractors address their risk management needs throughout the project life cycle.

Many multinational contractors will jump on these opportunities, already having P3 experience in their home market. For sureties, the challenges will be working with these new entrants. The way surety is done in the U.S. is a new risk management experience for them. Elsewhere, surety bonds are much closer to a banking relationship than an insurance relationship. P3s are also very complicated contractually; therefore, having a surety with legal expertise can be advantageous.


MARCH 11TH, 8:01 A.M.
A CONTRACT WON AND A RELATIONSHIP REAFFIRMED
IN AN INSTANT,
ERIC LOFTON SAW THE VALUE OF CNA SURETY
It would be their largest contract undertaken — installing the HVAC system for the nation's largest new shopping mall. Needing to provide a Performance and Payment Bond, Eric Lofton worked closely with his independent insurance agent and the experienced underwriters from CNA Surety. Eric's agent arranged a site visit with the mall developer, and helped Eric secure the bond that ultimately sealed the deal. Way to build your business, Eric.
To learn more about the complete range of CNA Surety bonds for construction, contact your local independent insurance agent, or visit www.cnasurety.com.
Construction • Education • Financial Institutions • Healthcare • Manufacturing
Professional Services • Real Estate • Retail • Technology • Wholesale Distribution
CNA
We can show you more.®
Please remember that only the relevant insurance policy can provide the actual terms, coverages, amounts, conditions and exclusions for an insured. All products and services may not be available in all states and may be subject to change without notice. CNA is a registered trademark of CNA Financial Corporation. Copyright © 2015 CNA. All rights reserved.

Choose health care by the numbers

99% Access to Coverage[1]

93% Renewal Rate[2]

More options. Preferred pricing. You belong with the engineering firms that consistently choose the ACEC Life/Health Trust to deliver value in numbers.

Call 1-877-280-0254 or visit uhctogether.com/acec30 for more information and to download "3 Keys for Choosing a Health Plan."

ACEC LIFE/HEALTH TRUST You Belong™

Insured and serviced by:

UnitedHealthcare®

[1]Network statistic based on GeoAccess information and UnitedHealthcare standard network access mileage criteria, 2013.
[2]Renewal rate based on average year-over-year ACEC Life/Health Trust persistency metrics.

The American Council of Engineering Companies (ACEC), the ACEC Life/Health Insurance Trust and UnitedHealthcare Insurance Company are three separate legal operating entities and, as such, the organizations are governed and function independently. UnitedHealthcare's services are provided with the authorization of the ACEC Life/Health Trust. Questions related to health benefits offered through the Life/Health Trust should be directed to 1-800-573-0415. Must be UnitedHealthcare insurance license products; and HMO products do not apply. ACEC membership qualification is determined by the association.

Insurance coverage provided by or through UnitedHealthcare Insurance Company or its affiliates.

Executive Viewpoints 2015 continued

What can GCs do before hiring a subcontractor to offset the risk of subcontractor failure?

BILL WATERS
Vice President of Contract Surety
CNA Surety

Considering how tight margins are right now, an effective program for subcontractor prequalification is vital to protecting a general contractor's bottom line. Having a prequalification process in place is the first step, but having the discipline to stick to it is equally important.

The day of the bid is not the best time to begin evaluating a subcontractor's financial position and capabilities. A general contractor should have an up-to-date database of approved subcontractors for all key trades. At a minimum it should contain current financial information, the amount of work they currently have underway with your firm, feedback from project managers on their current performance, and a letter from their bonding companies indicating their bonding limits. As an added protection, it would be smart to get a project-specific letter from their sureties indicating adequate support or better yet, a bid bond. (Then, of course, require the subcontractor to provide performance bonds to provide the best protection for your project.)

It takes work to maintain the database, but the costs of not doing it can be substantial. The more work the GC can do to prequalify a sub before bid day, the lesser the risk of sub failure and diminished profits on the job.

JOSH PENWELL
Vice President, Contract Underwriting
Merchants Bonding Company

The most effective and cost efficient method for an owner or general contractor to mitigate the risk of contractor and subcontractor failure is to require performance and payment bonds from a qualified surety. The performance and payment bonds will provide protection to the owners, architects, lenders, subcontractors, and suppliers throughout the entire project. A sophisticated general contractor should have a formal subcontractor bonding policy in place that clearly determines when bonds should be required from subcontractors. Additionally, there are several advisable methods for a general contractor to assess the qualifications of a subcontractor prior to awarding a subcontract. A general contractor should have a subcontractor prequalification form that includes information on the subcontractor's length of time in business, management team, past completed projects, list of suppliers/subcontractors to call for references, public record information, banking relationship, surety company and bond capacity information, and insurance information. Developing a "scorecard" of a general contractor's experience with particular subcontractors is also a good idea. This will benefit the general contractor when considering using repeat subcontractors. The scorecard would evaluate the subcontractor's supervision, scheduling, paperwork, safety, timeliness of payment to other subcontractors and suppliers, and communication. Lastly, the surety company and bond agent for a general contractor can often provide information regarding the reputation of particular subcontractors.

BOB STAPLES
Senior Vice President, Surety
Allied World National Assurance Company

Simply put, it is in the general contractor's (GC) best interest to transfer subcontractor default and project completion risk away from the GC to a qualified third party. There are two readily available products available for this purpose: surety performance and payment bonds and subcontractor default insurance.

While both products are readily available, only surety bonds deliver a complete subcontractor prequalification process while at the same time transferring project completion risk from the GC. Surety prequalification is a rigorous, specialized process by which the surety assesses the subcontractor and supports its judgment by issuing performance and payment bonds. Performance bonds assure the subcontractor is qualified to perform the work while protecting the GC and project owner from financial risk should the contractor default. Payment bonds assure that specified laborers and suppliers associated with the project will be paid.

What are the benefits of prequalified contractors?

- Increased assurance subcontractors complete their contracts on time and within budget
- Assurance the GC will not pay twice for the same work items if the subcontractor fails to pay suppliers

With the primary emphasis on subcontractor prequalification performed by a reputable surety, the resulting subcontractor default mitigation process greatly enhances the chances for successful project completion.

Executive Viewpoints 2015 continued

HENRY W. NOZKO, JR.
President
ACSTAR Insurance Company

A general contractor could be faced with a cost overrun from the failure of just one key subcontractor. A key subcontractor could disrupt the entire project schedule, resulting in possible liquidated damages from the owner or delayed claims from other subcontractors, or expenses of performing work out of sequence, and/or the cost to replace a subcontractor.

Certain practices might reduce the chances of being subjected to a subcontractor failure. The extreme low bidder should be avoided. Invariably, they crater at the worst possible time causing a parade of unexpected costs, usually far greater than the bid spread. Avoid the chronically inferior subcontractor. The cost of babysitting can be high. There are other problems with a weak subcontractor like federal tax liens, voided insurance, or problems from equipment or material not ordered correctly or timely. Make sure the subcontractor has performed jobs of equal size and/or similar scope. Request and review the subcontractor's financial statement. Check for filed suits or tax liens. Check with other general contractors who previously engaged the subcontractor. Require a bond. That would signify another set of eyes has previously approved the subcontractor, and help will be available should a default occur.

JOHN GAMBINO, ALLIANT
Senior Vice President, Construction Services Group
Alliant Insurance Services, Inc.

Subcontractor prequalification is fairly commonplace in today's construction industry. In order to offset the risk of subcontractor failure, a general contractor needs to have a solid proven prequalification process in place and, most importantly, adhere to the established process. It is important for a general contractor to remain diligent and consistent in its risk analysis. Companies should be disciplined and never become completely comfortable with a subcontractor they are hiring. Each project and buy out must be reviewed individually. From a credit perspective, financial statement review and backlog tracking practices are standard procedures. Understanding subcontractors' backlog composition and the amount of work they have with others is valuable information. Avoid aggregation issues with any one particular subcontractor.

Inherent risks of subcontractors include: nonpayment of suppliers and sub-subcontractors, changes to the principal or management of the subcontracting firm, and liens resulting from disputes between the subcontractor's subs and suppliers. By implementing the right prequalification practices, these risks can be substantially mitigated. Perform the basics and interview the subcontractor's team during a full scope review and reference check supply chain and labor issues. The bottom line is to have a strong backup plan in case something goes wrong.

W. MILTON SMITH, CRIS, CIC
Senior Vice President
McGriff, Seibels & Williams

As the construction industry begins to show signs of recovery, backlogs are beginning to creep up. While this is certainly positive news, it also presents some challenges as well. Historically, the industry has seen spikes in subcontractor failure occur during a recovery due to the effects of a downturn. Financial deterioration and capacity reduction due to layoffs place contractors in a vulnerable position as the work begins to pick back up. As a result, a thorough pre/continuous qualification process becomes paramount to preventing/minimizing subcontractor default.

The following are some basic considerations for subcontractor pre/continuous qualification. A periodic review of a subcontractor's balance sheet is extremely important. Key elements of this review include working capital, net worth, and debt to equity ratio, paying particular attention to cash flow. This is critical to understanding a subcontractor's susceptibility to a slow or hung receivable. Additionally you should review historical performance, backlog, aggregation of exposure with a particular sub, capacity for work, and bondability.

No qualification process is fool proof. As a backstop to subcontractor qualification, contractors should use surety bonds to protect themselves from potential losses. ■

When Contractors Play Surety

GREGORY HORNE, Assistant Vice President of Contract Surety at Liberty Mutual Surety

The request to provide surety credit on behalf of another contractor is inevitable. Whether the request comes from a subcontractor, relative, former project manager starting a new business, or from business development opportunities with a promising Disadvantaged Business Enterprise, the risk is the same—guaranteeing the performance and payment obligations of a contractor who cannot get a bond. A contractor needs to understand the risks associated with these requests and should discuss these matters with counsel.

The surety industry is the customary guarantor for a contractor's performance and payment obligations. A surety's job is two-fold—prequalify a contractor and guarantee the work. When a contractor cannot get a bond, it means the surety is not comfortable with its ability to complete the project.

When a contractor is asked to utilize its surety credit on behalf of another contractor that could not obtain a bond for the project on its own, the contractor's considerations should include:

- How to ensure successful performance?
- How to ensure all subcontractors and vendors are paid?
- What remedies are available when something goes wrong?

Contractors achieve success through control. Control often is achieved through ownership. In situations where contractors provide their surety credit on behalf of another contractor, ownership sometimes is not possible, and there may be significant limitations on the contractor's ability to control the situation.

Providing surety credit on behalf of another contractor can take various forms—a Joint Venture, an undisclosed or "silent" Joint Venture (JV), indemnifying with a Teaming Agreement, or simply providing third party indemnity. The pros and cons vary.

A Joint Venture is the most favorable arrangement to provide surety credit on behalf of another contractor. In this situation, the JV partners share the work, but one party provides 100 percent of the bond. Roles, responsibilities, and controls are established in the JV Agreement, an enforceable, legal document. Perhaps most importantly, the JV has privity of contract with the owner, giving the JV partners the responsibility and the right to complete the contract. Providing surety credit through JV arrangements is most common when a larger contractor needs complimentary expertise from a smaller or local contractor. Large, altruistic contractors sometimes form JVs to provide experience to a friendly contractor.

"Silent" JVs often are formed for many of the same reasons and provide many of the same benefits as open JVs, with one major exception—because the JV is not disclosed to the owner and the JV is not the contracting party, the lending contractor has no privity of contract. So while there are contractual rights and obligations between the JV partners, the "silent" partner has no ability or right to interact with the project owner. Without privity of contract, the indemnifying contractor is a bystander while the owner, surety, and principal work out any project problems.

Providing indemnity in conjunction with a subcontract and teaming agreement with a Disadvantaged Business Enterprise (DBE) general contractor is another situation where a contractor may be asked to provide surety credit on behalf of another contractor. Small Business Administration (SBA) eligibility rules generally prohibit a larger contractor from joint venturing or exercising control over the DBE for set-aside work, though some set-aside programs do allow for a formal Mentor-Protégé arrangement or teaming agreements when approved by the SBA. Both the DBE and indemnifying contractor face significant civil and potentially criminal sanctions if control is exercised beyond the set-aside program's parameters. It is important that both parties seek legal counsel with respect to set-aside projects and fully understand the requirements of these programs.

Indemnification arrangements offer no privity of contract for the lender of surety credit. The result—the indemnifying contractor has no legal ability to mitigate a breach of the prime contract with the owner. Further, the surety may find itself in a sticky dispute between the indemnifying contractor's expectations and the surety's obligations. The indemnifying contractor may not be pleased with the outcome or the process, as the surety must satisfy its obligations to the bond obligee, claimants, and/or principal, irrespective of the unrelated indemnitor's desires and expectations.

A surety bond represents an affirmation that the contractor is qualified to complete the project. The surety pledges its balance sheet as evidence of its confidence and as a source of funds to complete the project in the event of a problem. When a contractor agrees to provide surety credit on behalf of another contractor, the indemnifying contractor effectively assumes the role of surety, and its surety assumes the role of reinsurer.

When considering indemnifying for another contractor, factors should include:

- Can we write a check for the full bond penalty?
- Can we implement acceptable controls?
- Do we have the expertise to complete the project if a problem occurs?
- Have we adequately ensured all subcontractors and vendors will be paid?
- What rights do we have if a problem occurs?
- Is the relationship exclusive with the borrower of surety credit?
- Is the arrangement compliant with applicable laws and regulations?
- Is the return worth the risk?

The surety industry is highly competitive. Every qualified contractor should be able to secure a bond. The unfortunate reality is that when the opportunity to extend surety credit arises, it means no surety is willing to accept the risk that the contractor can complete the project and pay its bills.

In light of this reality the question for management is then very simple—is this potential opportunity truly worth the risk? ■

Gregory. S. Horne is assistant vice president of contract surety at Liberty Mutual Surety and can be reached at gregory.horne@libertymutual.com.


ALLIANT
CONSTRUCTION
SERVICES GROUP
360
risk advisors offering a
360°
view of the construction
insurance market.
THE NEW OPTION
www.construction.alliant.com
construction@alliant.com
Alliant

Capacity Availability and New Entrants

JOHN GAMBINO, Senior Vice President of the Construction Services Group at Alliant Insurance Services, Inc.

Construction activity in 2015 is up from recessionary lows but is still below peak levels. The U.S. construction market is expanding, but not significantly. We expect the market to continue to grow at a slow and steady pace well into late 2016. The private market is expanding faster than the publicly funded arena due to budget constraints throughout municipal, state, and federal agencies.

The good news for contractors is there is plenty of surety capacity available to support their expansion plans. Some regional bonding companies have expanded their geographic scope of operations to take advantage of premium potential being generated in more active construction markets. In some instances, we have seen new underwriting entrants endeavor to establish themselves and differentiate from some competitors by expanding single job and aggregate program limits to attract new contractor clients. The abundance of capacity and increased competition has impacted surety rates to some degree.

> **Anticipating future construction and predicting what the economic environment will be for the surety industry is difficult, but the near term extending into 2016 appears stable.**

Surety results in 2015 should be consistent with those experienced in 2014. Some modest top line growth is likely given the increased construction activity. Favorable loss trends experienced in recent years should continue into 2017. All of the new underwriting entrants have the experience and balance sheets needed to engage in this market in a meaningful way. The keys to sustainability with the newer underwriting facilities will be their ability to avoid major losses and capability to create competitive advantages that generate profitable returns over time.

Surety is a relationship business and, on a whole, had a period when investment in training was not a priority. The new entrants are leveraging this market reality to compete with the leading carriers. The competitive wage and benefits packages that are being offered in the market are luring some key underwriting staff away from leading carriers. As a result, some of the primary writers are challenged with employee retention issues. To some degree, primary writers have to not only simply protect their accounts, but also protect their key people as well. It is not difficult to envision how underwriters can leverage their prior knowledge of desirable customer profiles to aid in speeding the sales process for the new entrants. In some instances, desirable deals are not subject to typical prequalification processes, and upselling of capacity occurs. New entrants are banking on their senior staffs' prior relationships as a way to differentiate themselves, and they are making themselves readily accessible to new business meetings.

As we have come to expect, the leading 10 carriers control the majority of the surety market with 65 to 70 percent of premium in 2014. For contractors with revenue in excess of $750 million, the universe of market options is reduced to six or seven surety credit providers. The top five sureties write the bulk of the major contract surety business. The larger and more established players have made substantial investments in their surety operations, including M&A opportunities over the years, that added critical scale to their business. Reinsurance for the surety line is readily available on favorable terms and attractive pricing.

Anticipating future construction and predicting what the economic environment will be for the surety industry is difficult, but the near term extending into 2016 appears stable. The prospect for growth within the surety industry remains positive but will remain below the total construction peak spending prior to the last downturn. While EU economies continue to struggle and Asia begins to cool off, even the slower economic growth outlook in the United States looks attractive to the rest of the industrialized world. We anticipate more foreign interest in the U.S. construction market, with more foreign companies attempting to capture market share in the U.S. The top sureties and new entrants are prepared to deploy the capacity needed to support the increased backlog demands of even the largest construction firms in U.S. ■

John Gambino is senior vice president of the Construction Services Group at Alliant Insurance Services, Inc. and can be reached at jgambino@alliant.com.

Risks and Trends for Middle Market Contractors As the Economy Improves

THOMAS FINN, Territory Manager for Zurich Surety

The construction industry is experiencing an upward trend since it bottomed out in 2011, and the mood within the industry is generally optimistic as trends indicate growth. The degree of market improvement varies by region and market segment. In Florida, for example, there are more than 100 condominium towers under construction in southeast portion of the state. In contrast to the private construction market, public construction spending still has not rebounded to pre-crisis levels.

Growth in construction spending is resulting in more opportunities for contractors, but margins are slow to improve and contractors are facing challenges with staffing from both craft and management resources. Legacy low margin work acquired within the past 24 months lingers in backlogs and impacts profit and cash flow.

The National Bureau of Economics Research reports 14 recessionary periods from 1929 to 2014. Interestingly, the longest and most severe recession in the last 70 years occurred between December 2007 and June 2009. Unlike any other recession, construction spending declined for three straight years after the recession officially ended. Construction spending improved in 2012, yet by 2014, spending still was 17 percent less than the peak in 2007. The surety industry historically has suffered increased contractor failures as the general economy and construction market migrate out of a downturn. If history repeats itself, higher loss ratios and contractor failures are lurking as the construction market heats up.

It is imperative to evaluate your business structure and make necessary adjustments to be prepared as the economy recovers. How did your organization change as a result of the five-year construction market retraction? If your organization had generated your top revenue five or six years ago, are you staffed today with the right people to take on that amount of work again? Is your financial base sufficient to support your desired revenue level? How is your debt load, higher than before? Are the same subcontractors and suppliers still in business and capable of operating at a higher level? As labor shifted into areas with more work, is there a sufficient qualified labor pool in your local market? Are your subcontractors bondable? As private work increases, how well do you know the owners for whom you are working? Are they sophisticated? Do they have a successful track record and history of prompt payment?

> **Partnering with a professional surety agent and a construction-oriented CPA firm will help identify risk and minimize downside.**

Brian Kirwin, partner of Kirwin Norris law firm in Orlando recently stated, "As construction picks up, we are seeing more issues on projects that are staffed by unqualified project management and superintendents. Contractors need to have the right manpower in place at all levels before expanding. You are only as good as your weakest project management team."

Contractors who have succeeded in the up and down cycles comment that there is a shift in the way business is done now. In years past, a job was agreed upon with a handshake, but now successful contractors are diligent about reviewing contract terms before starting a job. Today, owners continue to push risk down to the prime contractor and then to the subcontractor. Understanding the details of your contractual obligations is critical and use of an attorney well-versed in construction law is an important risk-prevention strategy. Likewise, partnering with a professional surety agent and a construction-oriented CPA firm will help identify risk and minimize downside. "Avoid accepting risk-shifting provisions," says Kirwin. "It's time to push back on onerous contract terms."

There is a saying in the surety world that "contractors don't go broke from too little work but from too much work." Extreme and rapid backlog growth, geographic over-expansion, and entering new fields of work can overextend human and financial resources, creating greater risk to the organization. Construction firms need to be disciplined in order to succeed in a growing construction economy. ■

Thomas Finn is territory manager for Zurich Surety and may be reached at tom.finn@zurichna.com or 407-810-0709.

You have a passion for improving America's bridges and highways.

We have a passion for supporting you.

You have a passion for making sure America's infrastructure is safe. You follow blueprints to the letter, using only best-in-class equipment, materials, and subs. Liberty Mutual Surety shares your passion. We work with your agent or broker to provide the bid, performance, and payment bonds you need, so that the roads we travel together are secure and intact. For more information, contact your agent or broker or visit **LibertyMutualSurety.com.**


GROW with
Common Sense Surety
MERCHANTS
BONDING COMPANY™
Merchants Bonding Company™ (Mutual), Merchants National Bonding, Inc. and affiliated companies.
2100 Fleur Drive, Des Moines, IA 50321 | 1-800-678-8171 | www.merchantsbonding.com
A.M. BEST
You Tube

First Surety Product to Receive Favorable S&P Credit for a P3 Project in North America

STAN HALLIDAY, Chief Underwriting Officer for Travelers Bond & Specialty Insurance, Construction Services, National Accounts in Hartford, CT

In the U.S. and Canadian market, performance and payment bonds are the long established and customary security required by public construction project owners. On the other hand, letters of credit (LOCs) have been the most commonly specified performance security product for construction projects outside of North America, including public-private partnership (P3) projects. With the increased use of P3s in the U.S., the question of security for those projects is paramount. The legal systems in the U.S. and Canada typically allow a surety to have a first right to a contractor's accounts receivables on bonded projects. With this critical asset committed to a contractor's surety, many lenders struggle to extend LOC capacity to U.S. or Canadian contractors beyond their excess cash balances. Given the extended duration of each project (often three years or more), a few projects could exhaust a contractor's available credit facility. To date, the Canadian market has tried to address the issue with government export bank guarantees of contractor LOC facilities, but this type of program likely has a limited shelf life in Canada and is unrealistic in the U.S.

In addition to the capacity challenge, LOCs also create a liquid demand risk for contractors that traditional performance bonds do not. Under most LOCs, the construction owner has the right to demand immediate cash payment from the contractor by an alleging that a default has occurred. Most contractors have experienced at least one particularly challenging construction project where they fell behind schedule and went out of pocket in order to finish the work. If a demand upon their LOC had occurred, it would have made a bad situation even worse. By virtue of placing an unconditional liquid instrument in a construction owner's hands, on which the construction owner is sole beneficiary, the delicate balance of risks between the construction owner and contractor shifts soundly to the construction owner's favor.

To provide the best security for P3 projects, and to help contractors faced with these LOC challenges, Travelers developed a new Expedited Dispute Resolution Performance Bond that will benefit many contractors looking to work on P3 projects, while providing construction owners and obligees the protections that they seek. Some of the bond form's key features include:

1. Coverage up to the full contract value for the design and construction work to be performed under the P3 agreement or contract;
2. A requirement that the contractor keep working and the owner continue to pay the contractor during the adjudication process;
3. Express coverage of liquidated damages and warranties;
4. A streamlined claims handling process and a quick, structured adjudication process supported by JAMS - The Resolution Experts;
5. Primary Claim Contact information; and, payment protection for subcontractors and suppliers.

Travelers developed a new Expedited Dispute Resolution Performance Bond that will benefit many contractors looking to work on P3 projects.

Importantly, the bond form does not include a liquid component that a construction owner could draw upon similar to an LOC. It relies instead on a surety's traditional performance bond options—finance, takeover, tender, or pay damages—plus a highly rated surety committed to promptly responding to a construction owner's demand. Combined with a structured dispute resolution procedure with tight time frames, in the event the surety disputes that it has any liability on the bond, the construction owner is assured of a quick resolution of disputes.

Travelers and two other large sureties, as co-sureties, recently have written this new P3 bond form, along with a 100 percent payment bond, for the $990 million Pennsylvania Rapid Bridge Replacement Contract. With this P3 bond form as part of the project performance security package, this is the first performance bond to receive credit as liquidity support equivalent to a 10 percent LOC per Standard & Poor's (S&P) criteria in establishing Construction Phase Investment ratings. The industry anticipates writing 100 percent performance and payment bonds for the $350 million Indianapolis Consolidated Justice Facility using this P3 bond form (assuming it reaches financial close as expected). Additionally, we currently are working with a contractor to have this P3 bond form approved on another large private infrastructure project in the Southeast. Our expectation is these projects will receive a similar liquidity support rating from S&P.

Construction companies that have an interest in this type of product should engage with their agents, brokers, and surety to discuss it in more detail. The bond form is an industry product that may be executed by any qualified surety company. If you are interested in seeing this unique form, please contact either Travelers (www.travelers.com) or The Surety & Fidelity Association of America (www.surety.org). ■

Stan Halliday is the chief underwriting officer for Travelers Bond & Specialty Insurance, Construction Services, National Accounts in Hartford, CT, and can be reached at jhallida@travelers.com.

Good Construction CPAs Are "Money"

You're Losing Out Without One

JOSH PENWELL, Vice President of Contract Underwriting at Merchants Bonding Company

A certified public accountant (CPA) firm that specializes in construction is critical to the success of the financial management of any contractor's business. Construction companies experience strong economic cycles and work in complex business environments. It is imperative for a construction company to be surrounded by a solid team of advisors in order to sustain profitability, and that team includes a construction-oriented CPA. All long-term successful contractors share this positive characteristic.

Construction accounting is unique. There are different methods of reporting income for tax purposes that are available to contractors. Surety companies prefer to see a financial statement where revenues are recognized on a percentage-of-completion basis of accounting, and a good construction-oriented CPA firm will provide this. The CPA firm should understand the complex accounting and tax issues required of contractors. A CPA firm that does not focus on contractors may not fully recognize all of the tax implications for a construction company or the strategies to mitigate taxes that are available to a contractor. Simply put, if the CPA is not construction-oriented, the result could be the contractor paying taxes the business does not owe.

A construction-oriented CPA is well-versed in the nuances of construction accounting. This will become increasingly more important considering the guidance by Financial Accounting Standards Board (FASB) regarding new revenue recognition standards. The objective of the new guidance is to establish the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers. A CPA firm that understands these kinds of changes will bring value to the relationship and is crucial to obtaining the optimum level of surety credit.

A construction-oriented CPA firm also will be a valuable consultant when choosing a software program for contractors. A sophisticated contractor will use an accounting system that can produce timely and accurate financial information. It is of great benefit for the contractor to have an internal accounting system that closely mirrors the CPA's financial reports. A construction-oriented CPA firm will make recommendations for software programs that accomplish this goal. The CPA firm also should be available to help implement the system, recommend when upgrades to the system are beneficial, and easily provide temporary support for vacationing accounting staff.

> **It is imperative for a construction company to be surrounded by a solid team of advisors in order to sustain profitability, and that team includes a construction-oriented CPA.**

The timing of the CPA's financial reports is critical for surety support. A surety company expects to review the contractor's fiscal year end report within 90 to 120 days after fiscal year end. A construction-oriented CPA firm will ensure the reports are promptly available to the surety, bank, and any other party that requires financial information to help support the contractor's operations. If the CPA's fiscal year end report takes more than 120 days to complete, the surety is required to make decisions regarding the contractor's surety credit based on out-of-date information. This will limit the contractor's surety bond capacity.

Most construction companies, particularly subcontractors, require the use of a bank-line of credit to help cash flow in their operations. Even general contractors that do not normally require it often have a bank-line of credit facility in place for the occasional short-term need for cash. A construction-oriented CPA firm that prepares the fiscal year end financial statement could be beneficial to a contractor's banking relationship. Just like a construction-oriented CPA firm provides comfort to the surety that the financial information is accurate and appropriately prepared, a banker also should receive the same level of comfort from the CPA's financial information. Since borrowing ability is important to the business operations of most contractors, a construction-oriented CPA firm can only help when qualifying for bank credit.

The benefits of hiring a good construction-oriented CPA firm are numerous. Keys to a successful CPA-contractor relationship are respect and trust, clear communication, mutual commitment, responsiveness, and availability. Finding a good construction-oriented CPA firm can come from referrals from surety bond agents and surety companies. Various industry associations also can be good resources. Strategically, using a construction-oriented CPA firm should be a priority for a construction company that wants to minimize their taxes, values their banking relationship, and wants to increase their surety capacity. ■

Josh Penwell is vice president of contract underwriting at Merchants Bonding Company and can be reached at jpenwell@merchantsbonding.com.

The Talent Drain's Not-So-Hidden Costs

DONNA POWERS, Vice President of Chubb & Son, and Director for Chubb Surety

Employment trends have not been kind to the construction industry. Baby boomers are retiring or planning to. In addition, many skilled workers left the construction field when the recession took its toll on the industry, and new workers are not replacing those who left at the same rate. A lack of educational focus on STEM (science, technology, engineering, and math) curriculums has contributed to a shortage of engineers and project managers. In addition, a shift away from vocational and technical programs and a lack of interest in related careers have produced fewer trade workers.

The numbers paint a bleak picture:

- Forty-four percent of surveyed firms said they encountered challenges securing qualified craft labor, and 45 percent said they lacked planners and project managers, according to KPMG International's 2015 Global Construction Project Owner's Survey.
- Similarly, 53 percent of respondents said they were facing shortages of skilled labor, a 2013 FMI study, "U.S. Construction Industry Talent Development Report," found.
- The FMI study also noted that 93 percent of respondents cited a "lack of skilled workers" as their biggest concern.

This labor shortage can have multiple negative effects, including:

- Workplace safety issues. The private construction sector recorded 828 fatalities in 2013, 3 percent more than in 2012, according to the Occupational Safety & Health Administration (OSHA). As construction jobs become more complex, and are completed by less experienced workers, the potential for accidents increases.
- Construction defects. Increased job complexity combined with decreased experience and staffing also can raise the likelihood of mistakes that lead to construction defects. These defects, in turn, sometimes lead to injuries.
- Increased job costs. Firms that must compete for a limited number of workers typically have to pay more for their labor.
- A deterioration in overall performance is the net result of these and other related issues.

Each of these issues is significant on its own, but in combination they lead to an additional challenge: They can affect the surety credit that contractors need to run their businesses. The construction company's expertise and ability to complete a job are an important factor in the surety provider's decision-making process. Being able to take advantage of increased work opportunities and to profitably execute on jobs is essential to future success.

As a contractor, how can you rebuild your talent pool of both skilled trade workers and project managers and engineers?

Recruit and Retain

Recruiting and retention should be an industry priority. By putting time-tested practices to work and adding new, high-impact strategies, construction companies can shore up their talent base.

1. Project and maintain a positive image, environment, and culture. The construction industry has long struggled with broad-brush perceptions of dangerous work conditions or limited opportunity. Establishing, maintaining, and communicating a culture that promotes values such as innovation, safety, and professional development can help set your firm apart. Join and support professional organizations. Actively recruit and retain qualified women and minorities, including for management positions. Commit from the top down to a rigorous safety program and ongoing training.

2. Start recruiting early. The earlier you can connect with young students to educate them on the rewards of careers in construction, the better. Consider participating in career fairs, even at the elementary school level. Introduce yourself to guidance or career counselors at local schools and ask how you can support their efforts.

The ACE (Architecture, Construction, and Engineering) Mentor Program of America offers an opportunity to reach high school students, who work in teams with industry mentors. Teams conduct mock design projects that involve roles such as architects, engineers, and construction management. More than 8,000 students a year participate in this program.

For potential job candidates, internships are a practical way for people new to the industry to gain experience and learn about the work and the culture of a company. You benefit as well; internships are your chance to evaluate whether someone shows the potential to be a good fit for your organization. To make the most of an internship, assign work that will help the intern develop professionally, explain how that work fits into the company's goals, and provide constructive feedback on performance.

3. Create a Millennial-friendly culture. Millennials, those aged 18 to 34 in 2015, now represent the largest proportion of the American workforce, according to the Pew Research Center. They're an important piece of the labor puzzle, but they have different priorities and ways of working than the generations that preceded them.

For instance, Pew found that 88 percent of Millennials prefer a collaborative workplace culture to a competitive one; 88 percent want "work-life integration," or the blending of work and life; and 74 percent want flexible work schedules. Employers that respond to these values will be better positioned to retain this group, who are less loyal to their employers than the generations before them.

Millennials also bear out their reputation as being tech-savvy and highly active on social media. According to Pew, 24 percent (the top response) cited their use of technology as what makes them unique. Eighty-three percent have placed their cellphone on or right near their bed while sleeping. Given Millennials' affinity for technology, companies that actively use social media platforms such as Facebook, Instagram, and LinkedIn can position themselves well to recruit and communicate with them. To help ensure you're projecting the right image, consider hiring a Millennial to develop and implement a social media strategy for your company.

From mentoring to Millennial recruitment, a few focused hiring and retention initiatives can help you avoid the negative effects of talent drain and keep you ahead of your competitors. Talk to your surety company about what you're doing to shore up your talent base. It's part of demonstrating you have a well-managed and nimble operation—a win for your company and a major step toward maintaining a dependable surety bond facility. ■

Donna Powers, a vice president of Chubb & Son, and director for Chubb Surety, can be reached at dpowers@chubb.com.