CONSTRUCTION EXECUTIVE

13th Annual

Contractors' Guide To SURETY BONDING

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13th Annual Contractors' GUIDE TO SURETY BONDING

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Surety Market Overview

A LOOK AT SURETY CAPACITY, AVAILABILITY AND LOSSES FOR EVERY SIZE CONTRACTOR

Economic indicators shine positively for the construction industry, and both surety capacity and availability appear strong for 2016, despite some risks and losses posed by talent shortages and productivity demands.

The Architecture Billings Index (ABI) demonstrates a healthy demand for design services, with a score of 49.1 in August and a score of 54.7 in July. The ABI showed the highest scores in the Midwest (56.1) and South (53.8).

According to the most recent Bureau of Labor Statistics report, September construction unemployment fell to 5.5 percent compared to 6.1 percent in August and 7 percent in September 2014. Overall, the construction industry has added nearly 40,000 jobs for the year.

Construction Executive and The Surety and Fidelity Association of America gathered the expert opinions of the top surety bonding and professional services firms in the United States. Their outlook for small, middle, large and mega-sized firms is outlined in the pages ahead. In addition, on p. 52, more experts share their insights in response to key questions affecting the entire building industry.

CAPACITY

Despite the fact that the construction economy continues to recover with backlogs growing stronger each year, there is still significant capacity for contractors of all sizes. Whether it is a small or mega-size contractor, capacity looks to remain extremely strong again in the year ahead.
—Michael J. Mitchell, The Graham Company

Capacity is substantial at all market levels. While the players are not always the same at the small and mega range, adequate surety capacity is available to support virtually any size construction operation.
—Chris Murphy, Travelers

The entry of several new sureties over the past few years, along with a favorable reinsurance market, has had a positive impact on surety capacity. For contractors that continue to focus on managing expenses and debt, as well as maintaining reasonable backlog, surety capacity remains plentiful for all market sizes. Surety capacity also remains available in the specialty surety markets for contractors that have weak balance sheets due to excess debt and poor operating results.
—Michael P. Cifone, Hudson Insurance Group

SMALL

Surety capacity in the under $10 million segment is robust. Longstanding surety carriers have been augmented with a number of newer market entrants to more than amply serve the small contractor community.
—Chris Hunt, Liberty Mutual

MIDDLE

Plenty of surety capacity remains available to contractors with annual revenues in the $10 million to $100 million range. 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 to $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. In recent years, our agency rarely deals with capacity issues for either existing clients or prospects.
—Mike Specht, Minard-Ames Insurance Services / INSURICA

Capacity for mid-market surety may be at an all-time high, and contractors that are working with the right insurance carriers and agents certainly can benefit. Many new markets have begun to enter this space, while traditionally small markets are beginning to reach up to the mid-market domain. We see further examples in which large and mega-market sureties now have greater interest in sliding back into mid-market opportunities.
—Robert Thomas, Hanover Surety

Qualified contractors will find ample capacity from their sureties.
—Edward Titus, Philadelphia Insurance Companies

The surety market for contractors performing projects under $100 million is very competitive. We are seeing an adequate amount of surety capacity in this market segment for properly capitalized and well-managed contractors.
—Josh Penwell, Merchants Bonding

Surety capacity remains strong in the middle market arena due to profitable results over the past several years. Senior management looks at the profitable results and allocates capital to this line of business as demonstrated by the new entrants into all segments of the marketplace. This ultimately increases overall capacity in the middle market.
—Antonio C. Albanese, Nationwide Surety & Fidelity

LARGE

There is an abundance of capacity in every segment of the market, with the middle to large segment being the sweet spot for the vast majority of surety companies.
—Matthew S. Haydon, Arch Insurance Company

MEGA

Surety capacity remains plentiful and competitive for the mega market from a handful of sureties, often working in co-surety arrangements. The surety capacity available often far exceeds the contractor's capacity to man the work, serving as a natural temper to uncontrolled growth. The issue of talent and labor shortages is driving the discussion.
—Susan Hecker, National Association of Surety Bond Producers (NASBP)

AVAILABILITY

There is ample availability in every segment of the market. Terms and conditions have been marginally deteriorating each year for the past few years, and we would expect this trend to continue as the surety industry, in general, has experienced very good underwriting results.
—Matthew S. Haydon,
Arch Insurance Company

Sureties continue to be hungry for more business even in light of the recent construction recovery. Surety availability is strong; this is truly a buyer's market regardless of the size of the construction company.
—Michael J. Mitchell,
The Graham Company

Many surety companies have an appetite for bonding all size contractors, and there have been recent market entrants that focus on small and middle, and some that focus on large/mega, although these entrants do not typically overlap each other.
—Chris Murphy, Travelers

SMALL

Availability of surety credit for contractors performing on work programs under $10 million is plentiful. Increasingly, automated, credit-based models are common at the lower end of the range, with traditional underwriting criteria more common toward the upper end. Collateral terms are not uncommon in the under $10 million segment.
—Chris Hunt, Liberty Mutual

Most small to mid-sized contractors have many options available to them regarding their surety needs. Successful contractors have an opportunity to increase capacity and improve terms and conditions of their surety program. Contractors that may have struggled during the past year also will find surety support in this market.
—Michael P. Cifone,
Hudson Insurance Group

MIDDLE

The surety market is extremely soft and surety support is readily available for properly capitalized and well-managed contractors. A large number of surety companies appear to be marketing for the contractors performing projects under $100 million. This creates a very competitive environment and adequate surety availability.
—Josh Penwell,
Merchants Bonding

Availability is not a problem for a qualified contractor. Due to the number of new entrants into the mid-market, coupled with some larger market sureties' entry into the mid-market, availability is not and probably won't be an issue for the foreseeable future.
—Alan P. Pavlic,
Old Republic Surety Company

The right surety carriers—those with proven track records of financial stability and delivering on their commitments—have ample availability to meet the needs and desires of contractors that have exhibited their staying power and sound business

acumen during the recent recessionary period. Coming out of this period, some work is rather erratic, exhibiting an uneven recovery, which creates some concerns about the quality and stability of backlog. However, carriers specialized in this market are willing and able to support a growing backlog of work when provided appropriate insight into contractors' current financial and operational framework.
—Robert Thomas, Hanover Surety

Surety companies continue to be hungry for new business, and medium-sized commercial contractors are a real focus for them. Underwriters have stepped up their marketing efforts with bonding agents to build their contractor books. In Arizona, more than 50 bonding companies are pursuing business in the state, so this provides agents and their contractor clients with many options. I would estimate that more than one-third of the sureties have the financial capabilities to support the bonding program for a $100 million-per-year contractor, and most of the remaining bonding companies can handle the needs of contractors in the lower end of the $10 million to $100 million range.
—Mike Specht, Minard-Ames Insurance Services / INSURICA

LARGE

Recent surety market entrants and longstanding industry leaders have bolstered surety availability to large contractors. With project complexity increasing and owners insisting on difficult contract terms, contractors in this segment rely on both availability of surety capacity and value-added support from their strategic surety partners.
—Michael Bond, Zurich North America

MEGA

While only a handful of sureties participate on mega accounts, the number of sureties participating is both adequate and growing.
—Susan Hecker, NASBP

Most mega contractors can obtain the bonding needed under reasonable terms. Sureties that are experiencing some loss activity are driving more difficult terms and conditions, while new (and unproven) capacity providers may offer more flexibility.
—James Bly, Alliant Construction Services Group

LOSSES

Losses have been low over the last two or three years despite the economic downturn and slow recovery. However, there is concern that with increased production pressures and new entrants into the marketplace, underwriting discipline may suffer, leading to increased claim activity as well as severity.
—Alan P. Pavlic, Old Republic Surety Company

The industry continues to be profitable. However, loss activity appears to be trending upward. Depending on macroeconomic factors, this trend could continue.
—Antonio C. Albanese, Nationwide Surety & Fidelity

Loss severity for most sureties is trending down. There is an increase in frequency in the small end of the middle market with an emphasis on the sub-trades.
—Edward Titus, Philadelphia Insurance Companies

MIDDLE

We have seen an increase in severity losses for middle market contractors as a result of some difficult projects and stringent contract terms from demanding owners. Risks have increased for contractors in this segment and even firms with strong reputations in the marketplace have experienced problems.
—Michael Bond, Zurich North America

Losses are present in the middle market segment, with fairly active frequency, while severity is limited to a handful of individual events. Contractors value surety carriers that offer thoughtful guidance to help effectively navigate changes in the market without becoming overly extended. The recessionary period has begun to move toward a period of growth, particularly in the private sector. However, the scars from the recession are still felt, especially on public works projects.
—Robert Thomas, Hanover Surety

MEGA

Over the last year, we have seen more surety losses greater than $50 million in value in the market since the 2004 surety crisis. While there has been an increase in loss activity, we are not yet at the level where the surety market is constricting due to the overall profitability of the market and the new capital that is emerging.
—James Bly, Alliant Construction Services Group

Executive Insights

How can a contractor take its bonding capacity to the next level?

JEREMY CRAWFORD
VICE PRESIDENT
CCI Surety, Inc.

The most important step in increasing a contractor's bonding capacity is working closely with its surety through an experienced surety agent. Contractors often make the mistake of looking for increased bond lines when the opportunity for larger projects present themselves only to find out they do not qualify. Making a surety agent aware of plans to seek larger projects ahead of time allows the agent to make recommendations about financial preparation, banking decisions, personnel choices and other factors that will affect how the account is viewed. It also shows the surety that a thoughtful assessment of future opportunities is under way.

Early input from underwriters can help contractors make decisions about equipment, debt management and banking decisions. My unofficial fourth "C" of underwriting is communication. Active communication among contractors, their agents and the surety helps them work together to anticipate and overcome any potential obstacles to meeting the contractor's bonding goals.

MICHAEL BOND
HEAD OF SURETY, EXECUTIVE VICE PRESIDENT
Zurich North America

Surety bonding capacity is a vital asset for construction firms looking to grow in today's hyper-competitive market. Contractors need to develop a holistic view of surety capacity. A complete financial presentation from a construction-oriented CPA and well-prepared internal statements are a must. Selection of a professional surety-oriented broker is a vital component as well.

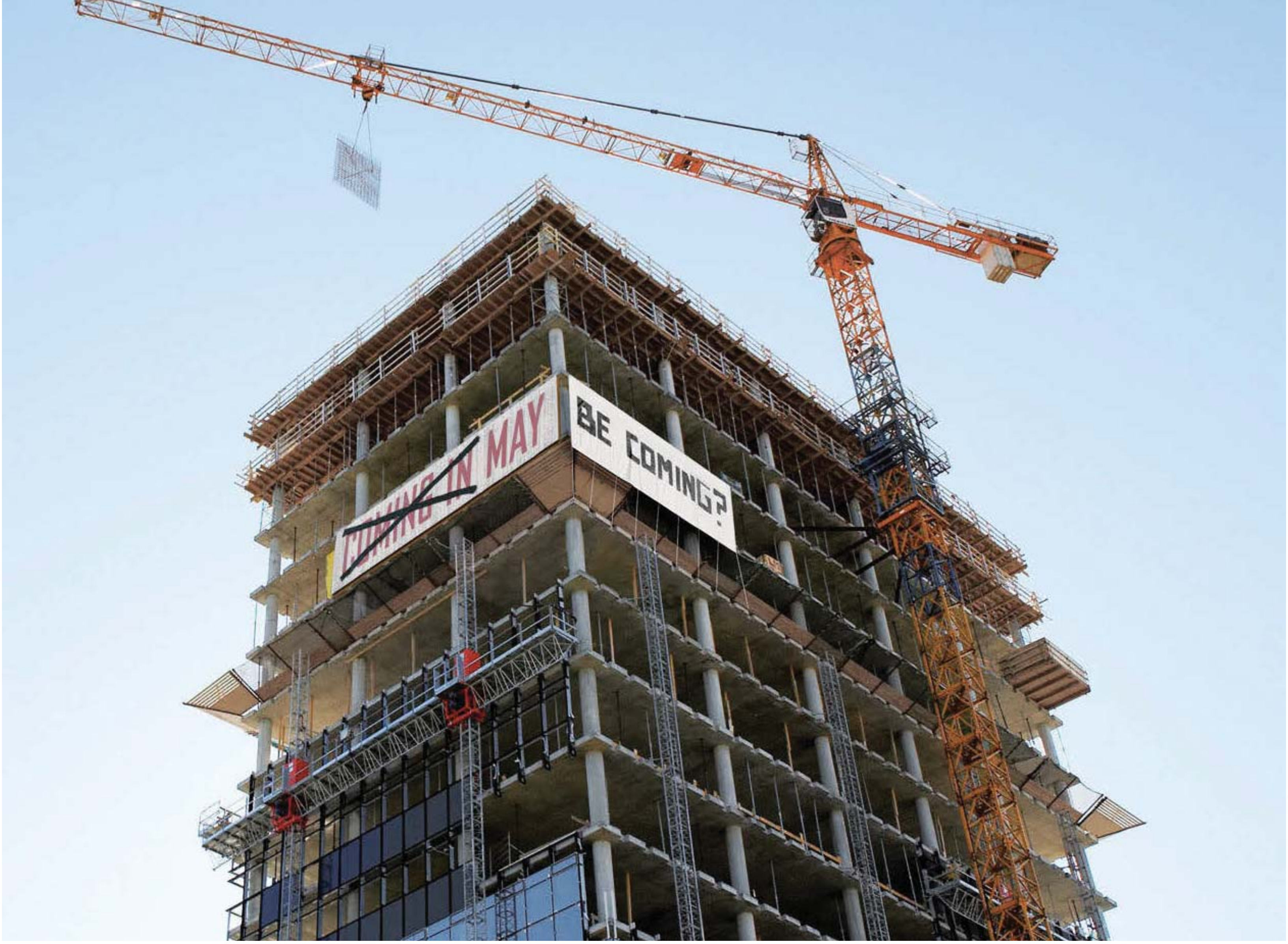
Contractors need to develop and present to sureties a strategic business plan for the type of work they intend to pursue, along with evidence that they have the managerial talent, craft skills and experience to successfully complete that work. This presentation should be in writing, and the contractor should be prepared to make personal visits with sureties. Sureties often look to the contractor's management capabilities as a tie breaker in surety bonding capacity considerations. Presenting complete financial data and a strong business plan will help the contractor achieve the desired level of surety support.

ANTONIO C. ALBANESE
VICE PRESIDENT
Nationwide Surety & Fidelity

The secret to taking bonding capacity to the next level starts with a focus on the core business and strong management controls. It's important to have a growing balance sheet and reasonable levels of equipment debt. The operation should be able to collect cash and handle liquidity needs with minimal outside working capital financing.

Relationships are also paramount. To be the best, they need to work with the best. The staff should be qualified and tenured. The CPAs, bankers and brokers/agents with whom they affiliate should be high quality. From there, they need to create and maintain good relationships, not only with their agent and bonding company, but also with subcontractors, owners, suppliers and architects.

Strong communication with their surety is also key. They should have regular meetings with their bond company so everyone is on board and understands the contractor's business plans.



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Executive Insights

How can a contractor take its bonding capacity to the next level?

MICHAEL P. CIFONE
SENIOR VICE PRESIDENT, SURETY
Hudson Insurance Group

Just because a contractor can increase its capacity does not mean it is ready to do so. A contractor should take its bonding capacity to the next level when it will help take profits to the next level. Operating the business at the next level involves changes to systems, personnel, infrastructure and cash flow. Obtaining a commitment from the contractor's banking partner is an important factor in increasing bonding capacity.

A contractor must demonstrate its ability to handle an increase in the number and size of its projects. In addition, a contractor that is expanding geographically and with unfamiliar owners will need to support its growth with a viable business plan. A contractor can utilize the knowledge and expertise of the surety and its agents.

Developing a strong project management team is critical to increasing profits and bonding capacity. Also, having an experienced workforce is in place will give a contractor an opportunity to prove that bigger can be better.

CHRIS HUNT
UNDERWRITING OFFICER
Liberty Mutual Surety

The desire to elevate bond capacity should be underpinned by a trusting relationship built on open, honest communication. Schedule recurring meetings with the surety and maintain a clear flow of information.

Being transparent with the surety is paramount. Problems routinely surface in the world of construction, and relaying those and the impacts on your company demonstrates confidence and credibility. Operate with a mantra of "no surprises." The surest way to adversely impact your creditworthiness in the eyes of the surety is to share bad news late in the game.

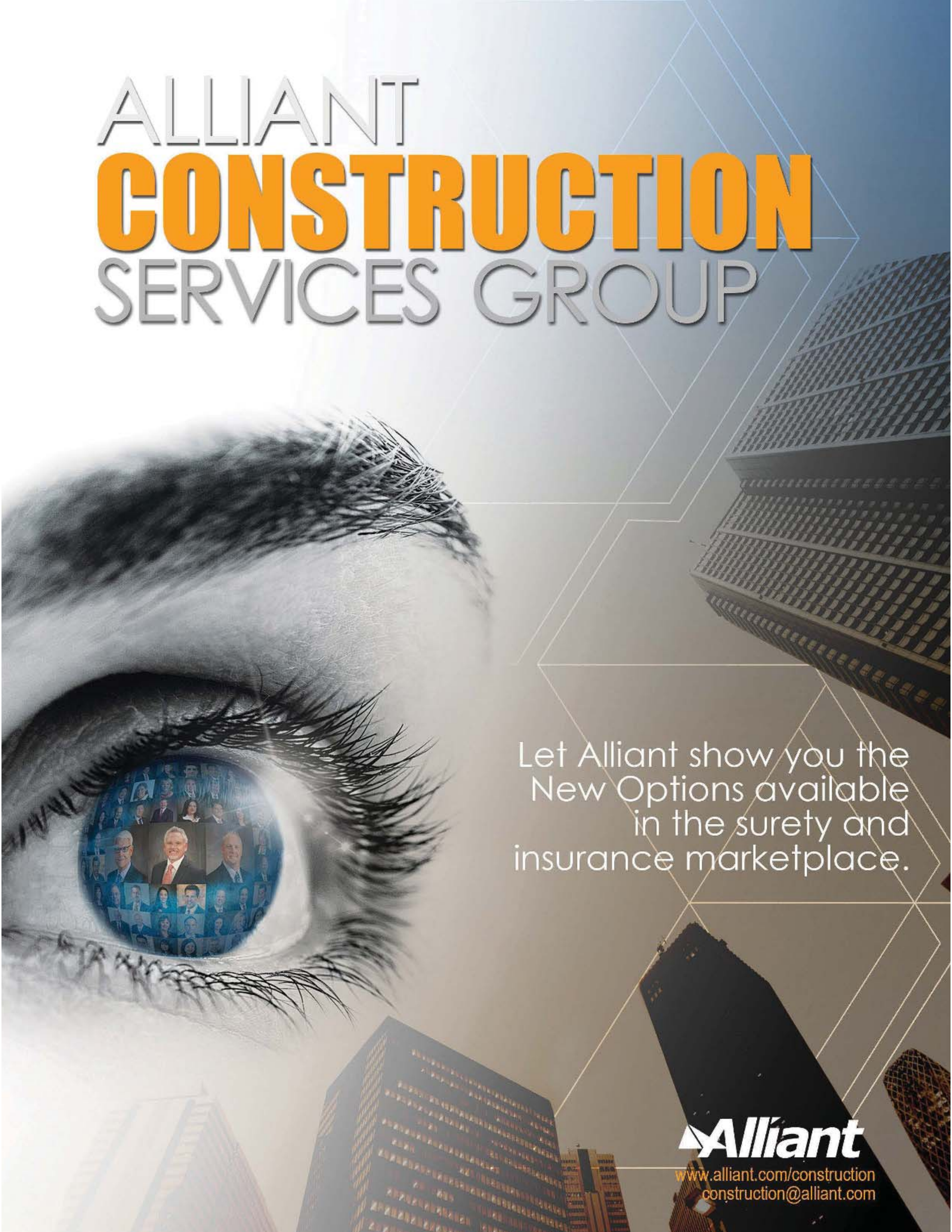
Reinvest in the business, build up your risk capital, shed debt and relentlessly guard your liquidity position. Surround yourself with top performers, including professional advisors, and craft a thoughtful business plan based on your core competencies. Communicate this to your surety, and assimilate their feedback as a trusted advisor.

SUSAN HECKER
EVP & NATIONAL DIRECTOR OF CONTRACT SURETY
Arthur J. Gallagher & Co.
PRESIDENT
National Association of Surety Bond Producers

Understanding where the risks are and how best to mitigate them is key to obtaining surety support for the business plan. Also needed are the best talent available in the right seat on the bus; a high-quality and well-utilized internal job cost accounting system; business partners immersed in the construction industry; a good continuity plan; and more cash and credit capacity than is typically necessary to run the business.

Be able to explain the new business plan and be prepared to defend your readiness. Anticipate the surety's questions, and make sure your quarterly financial presentation is thorough.

Sureties often can assist with ideas or resources to help mitigate problem situations. They will not tolerate finding out about problems late in the game. Your credibility is the most important facet of your relationship with your bonding company.



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Executive Insights

How can a contractor take its bonding capacity to the next level?

JAMES BLY

MANAGING DIRECTOR
Alliant Construction Services Group

Five key factors will help improve a surety program, whether it's to increase bonding capacity or secure for an acquisition, shareholder buyout or recapitalization strategy.

1. Monthly financial statements and WIPs within 45 days of month's end demonstrating the ability to manage an increased workload.
2. Disciplined internal cash forecasting, headroom on bank covenants and adequate cash for startup of work.
3. Annual budgets with quarterly updates that include details about backlog burn and new work targeted to meet the plan.
4. Mitigation factors implemented to manage the risk of labor availability, productivity, schedule, material escalation and subcontractor default.
5. Removal of cost reimbursable work, runoff from the bid/award to project start and joint venture backlog from your surety capacity limit.

How does character impact a contractor's bondability?

CHRIS MURPHY

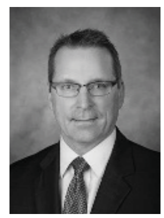
CHIEF UNDERWRITING OFFICER, CONSTRUCTION SERVICES
Travelers Bond & Specialty Insurance

There is no element of a surety's decision-making process more powerful than consideration of a contractor's character. What sureties emphasize most often is the contractor's reputation for honesty, fair-dealing and doing what it says it will do. A contractor can have an impressive project résumé, sufficient capital invested in the business and even an impressive earnings history. Those attributes are nice, but without strong character they are not enough to embark on a business relationship that depends on trust and transparency.

Character even extends to financial reporting. A contractor's financials are largely based on its own estimates of future cost and profit estimates, the dependability of which has a huge influence on how the contractor is perceived by a smart surety underwriter. Under-delivering on shared expectations of the outcome of projects can create a glass-half-empty perception that is hard to undo.

ALAN P. PAVLIC

PRESIDENT & COO
Old Republic Surety Company



When it comes down to end results, "character" may be the most important of the three "Cs" of surety. We have to be able to rely on a contractor's character in the underwriting process. We have to believe and trust the information that is received from a contractor, both verbal and written.

As a surety underwriter, you have to trust that the contractor is providing you with correct information—not just financial, but also job, management and continuity information. We have to be able to rely on the contractor's word that capital will stay in the firm, and that jobs will only be bid in specific geographic areas, as well as within the contractor's expertise.

Character is especially important in the claims process. Especially when a loss may be eminent, the contractor's true character is revealed. Capacity and capital can hide some sins, but not all of them. Poor character in a contractor will only lead to one thing in the long run, and that is losses.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How does character impact a contractor's bondability?

H. THOMAS DAWKINS
SENIOR VICE PRESIDENT
Rutherfoord, a Marsh & McLennan Agency

The surety/contractor relationship is viewed as a partnership with common interests. When an issue of trust surfaces, it is nearly insurmountable. Both capacity and capital are quantifiable situations that can be addressed and remedied, but character, honesty and trust are areas that cannot be corrected once breached.

For many years, most surety companies had a cardinal rule of not bonding accounts without conducting face-to-face meetings. Today's standards include personal credit reports and even background checks as they look for inconsistencies. A lack of proper disclosure may lead to an issue of trust along with inconsistent financial reporting. Any semblance of non-disclosures or improprieties may lead to the surety asking the agent to place the account elsewhere.

On the flip side, a surety that is comfortable that a client exercises honest and solid ethical business practices will be in position to get the best possible consideration when a surety is faced with a difficult underwriting decision.

HENRY W. NOZKO, JR.
PRESIDENT
ACSTAR Insurance Company

Character is considered a component of underwriting by all surety companies. The weight that character contributes to a surety's underwriting decision varies among sureties and underwriters, and might differ from account to account. Suffice it to say, character always has some influence on the underwriting decision.

For example, this surety generally over-weights character. One contractor with a flawless performance record meeting credit obligations and uneventfully completing projects for more than 20 years, but has a weak financial statement with negative equity, would most likely score higher than another contractor with sufficient capital but that dates back just a few years and has had a few hiccups with credit obligations and job performance.

Character can replace capital, but capital cannot replace character.

JOSH PENWELL
VICE PRESIDENT OF CONTRACT UNDERWRITING
Merchants Bonding

The character of the shareholders and leadership team of a construction firm is a critical component for a contractor's bondability. Successful construction companies are experts at managing risks, and it is reasonable to assume that the manner in which the owners of a construction company handle their personal matters is a reflection of how they operate their business.

A risk-averse owner will generally bid work more conservatively and incorporate many risk mitigation techniques into contracts. An owner of a construction company that carries an excessive amount of personal debt obligations may be viewed differently than one with a more conservative lifestyle. The type of investments made by an individual is also a reflection of how conservative the individual is.

Surety capacity will be positively impacted if the surety determines that the shareholders and leadership team have high ethical and moral standards, and are determined to be honorable individuals with high character.

Executive Insights

How does character impact a contractor's bondability?

PETER WORTHINGTON

UNDERWRITING CONSULTANT

Liberty Mutual Surety

All three "Cs" are important to a surety underwriter, and the most intangible is character. It takes a significant amount of time to develop a relationship—a true partnership between the surety and contractor that is strengthened in good times and not-so-good times. Having a contractor that does what it says it will do in both good and tough times creates that understanding between the parties. In many cases, the true character of a person arises in difficult times. Character begins early in the lifetime of the contractor and is developed over time.

Building the relationship with the surety, project owner and contractor will yield great results for all involved. Character is key to the underwriter's assessment of the contractor's overall credit quality, and only the contractor can influence the assessment. Having that understanding will allow additional surety support when the numbers may not add up.

MICHAEL J. MITCHELL

VICE CHAIRMAN

The Graham Company

In my opinion, character is the most important factor when it comes to bondability. Having a strong character is powerful; it means the surety can trust the principal or owner, and trust that shared financial information is credible and accurate. That trust will always outweigh capacity and capital. There is an instinctual element that is inherent to determining bondability. If a surety does not have a good feeling about supporting the contractor, then there is cause for hesitation, and that pause communicates more to the surety than anything a contractor can say or do.

On the contrary, if you have a strong character, a surety will overlook some capital and capacity issues and will look for ways to support you. This is human nature: When you like and trust a person, you instinctually want to support them, but it all starts with having a strong character.

What cash management techniques should contractors employ in order to be successful as the economy recovers?

EDWARD TITUS

SENIOR VICE PRESIDENT, SURETY DIVISION

Philadelphia Insurance Companies

Cash flow management techniques require periodic evaluation and review that must be embraced at the top and become part of a contractor's culture.

- Ensure staffing and equipment acquisitions don't outpace revenue, determine proper tax status and evaluate captive versus traditional insurance.
- Review areas where cash is typically trapped: underbillings, pending change orders, receivables, retentions and inventory.
- Evaluate benefits of self-performing versus subcontracting, process billings and change orders in a timely fashion, obtain documentation before performing work out of scope, review costs to complete at a project level, identify changed conditions and take advantage of vendor discounts.
- Build strong working relationships with owners, banks, the surety company and legal counsel.

In today's economy, businesses are increasingly taking their surety's financial strength into consideration when evaluating their contract and commercial surety bond needs. Philadelphia Insurance Companies (PHLY) recognizes this need and offers a competitively priced suite of bonding options for well qualified contract and commercial surety accounts. PHLY's surety business model is focused on building strong relationships with its accounts, leveraging an experienced team of surety professionals, and a financially strong insurance company while offering a comprehensive portfolio of contract, commercial, subdivision & custom surety bond products.

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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?

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

The bonding industry now understands how the various disadvantaged business programs work and continues to focus on full disclosure to the contracting officers about the arrangements for bonding. Given the fraud cases concerning contractor teams that violated the disadvantage business programs' rules and regulations, underwriters and sureties want to avoid receiving 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, in many cases, are required 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.

In what ways can improved construction accounting software impact a contractor's business?

MATTHEW S. HAYDON
SENIOR VICE PRESIDENT, COMMERCIAL SURETY
Arch Insurance Company

Of the four primary financial data sets sureties study, only the work-in-process (WIP) schedule provides any clue as to the contractor's future earnings and future cash flow.

One of the common challenges of the surety is "the big job." The surety can evaluate the capabilities of the contractor, but can't forecast the periodic earnings and cash flow needs of a three- or four-year project and how it overlaps with the runoff of the existing backlog.

Accounting software that evaluates a potential job from a financial impact perspective allows the contractor to see when it might be cash flow positive (or negative). Being able to model and test delays in payment or unanticipated cash flow disruptions enables the contractor to plan for unforeseen financial impacts.

Having reports that forecast earnings and cash flow based on the current WIP and potential new jobs greatly reduces the risk to the contractor and the surety.

ROBERT THOMAS
PRESIDENT
Hanover Surety

The business value of quality accounting software manifests in greater accuracy, timeliness and reliability of job performance measurements.

Today's construction accounting software should provide a seamless and integrated system that brings together the original estimate with the job budget, including the cost estimates, general conditions, contingencies and profit estimates. Against these targets, the actual costs incurred on the project can be evaluated among many cost code elements to give the project management team an early and more exact indication of cost overruns or acceleration. This creates the opportunity to proactively apply corrective measures to contain or reverse the impact of cost overruns.

These improved outcomes provide the construction company an opportunity to achieve more consistency in its project results and greater confidence in the management systems governing the backlog activity.

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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.

The Hanover brings a distinctive value to its bonding relationships. The company's "A" rated financial strength, experience and strong working partnerships with the best agents and brokers in the United States create real synergies to meet the needs of individual contractors and their specific jobs.

The Hanover's people are its biggest asset. They create value through their industry expertise and customer commitment. Perhaps most important, is that the team at The Hanover Surety includes many of the industry's most knowledgeable and experienced professionals, who offer unparalleled market knowledge, underwriting insight and responsive service, along with risk management acumen.

At every level of the organization, there is the understanding that no two contractors and no two construction jobs are alike, and the surety team is committed to creating solutions that are tailored to meet the demands of every different company and building project. This allows contractors to know when they choose The Hanover Surety, they are choosing a carrier with the strengths and commitment to customers that they need.

With the countless details and risks involved in managing your construction projects, we suggest you also make sure you have the right surety team to protect your business. Experienced contractors who really know their business recognize the importance of working with carriers and agencies that are equally experienced and knowledgeable about the intricacies of construction surety bonding.

The Hanover commitment is to deliver valued solutions that meet your unique needs.

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.

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

Liberty Mutual Surety, a member of Liberty Mutual Insurance, is the second largest surety in the United States and a leading surety globally. With underwriting offices in seven countries and bonds issued throughout the world, we work with agents and customers to build mutually profitable relationships by providing smart business solutions, ease of doing business, and consistent, responsive service through knowledgeable surety professionals.

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• Our Global Risk division provides capacity for international and U.S. multinational customers. Through affiliated companies and strategic 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.

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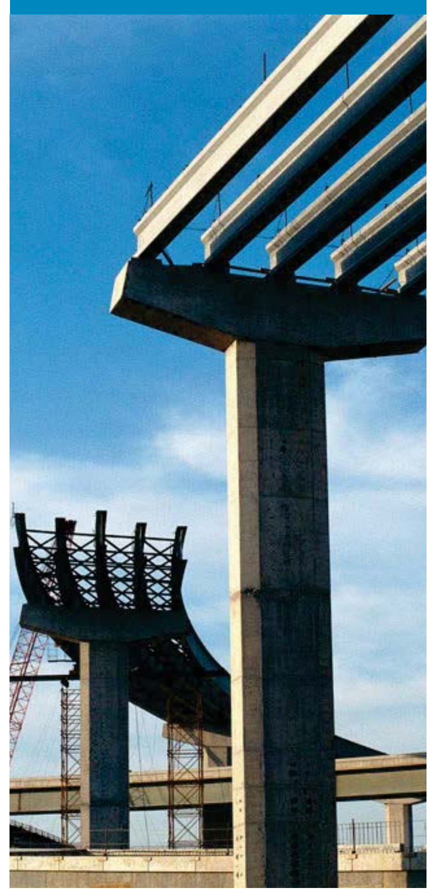

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Keep It Coming and Bring It On!

With our bonding capacity at $50 million, last year we proclaimed "**Bring it on!**"…and you did! Old Republic Surety's double-digit growth in contract bonds over the past several years is a healthy indication that our capacity and our expertise are welcome additions in the middle market arena. In preparation for another banner year, Old Republic Surety's $50 million of contract bonding capacity, a 10-fold increase since 2004, positions us to assist the construction industry with bond programs based on flexible, common-sense underwriting. We write contract bonds in all 50 states. **Keep it coming and bring it on!**

We've got an option for smaller, growing contractors. Our FastBond 750 program not only offers a quick, flexible answer for a smaller bond, but it also opens the door for small contractors wanting to grow. Coordinate our FastBond 750 program with essential underwriting elements to easily transition into a standard bond program. Better yet, you'll be able to keep the same underwriter and relationship as you grow with us.

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OLD REPUBLIC SURETY

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- Subjectivity is flexible
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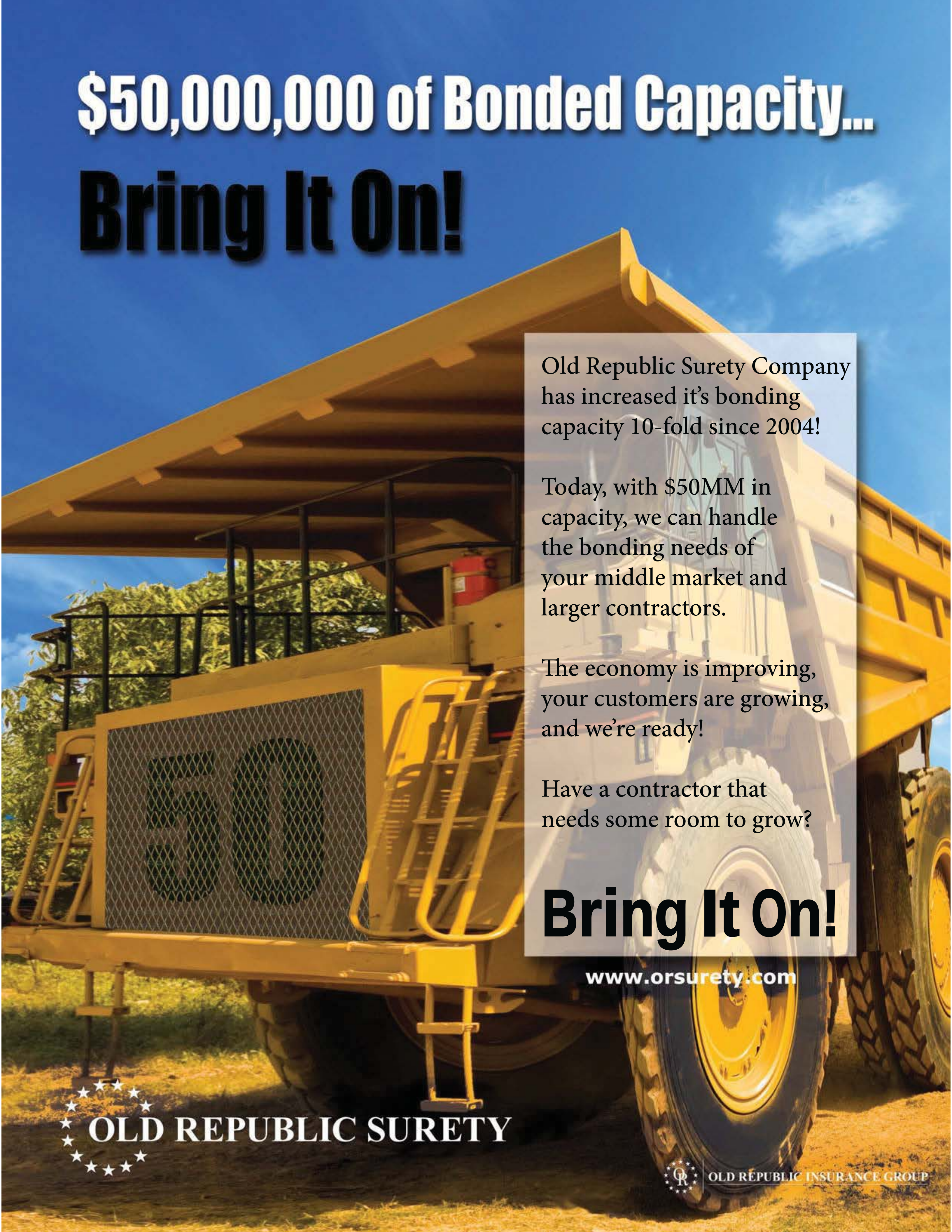
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Today, with $50MM in capacity, we can handle the bonding needs of your middle market and larger contractors.
The economy is improving, your customers are growing, and we're ready!
Have a contractor that needs some room to grow?
Bring It On!
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Hudson Insurance Group is a specialty insurance group that writes business on an admitted basis through Hudson Insurance Company and on 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.

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Regional knowledge of the construction marketplace 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 specialty trade contractors.

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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.

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Deb Nelson, VP Commercial Surety
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Juli Dahlgren, VP Specialty Contract
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[1]Nationwide Mutual Insurance Company®, 2014, *www.fms.treas.gov*. Coverage is provided by Nationwide Mutual Insurance Company®and affiliated companies.
[2]Affirmed June 2014
[3]Affirmed May 2014

Nationwide®: Strength. Stability. Solutions.

Nationwide® represents a wealth of experience in 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. We pride ourselves on developing a close working relationship with our agents, brokers, and principals in order to ensure a consistent underwriting approach to mitigate losses.

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The Evolution of the Surety Marketplace

BY MIKE BOND

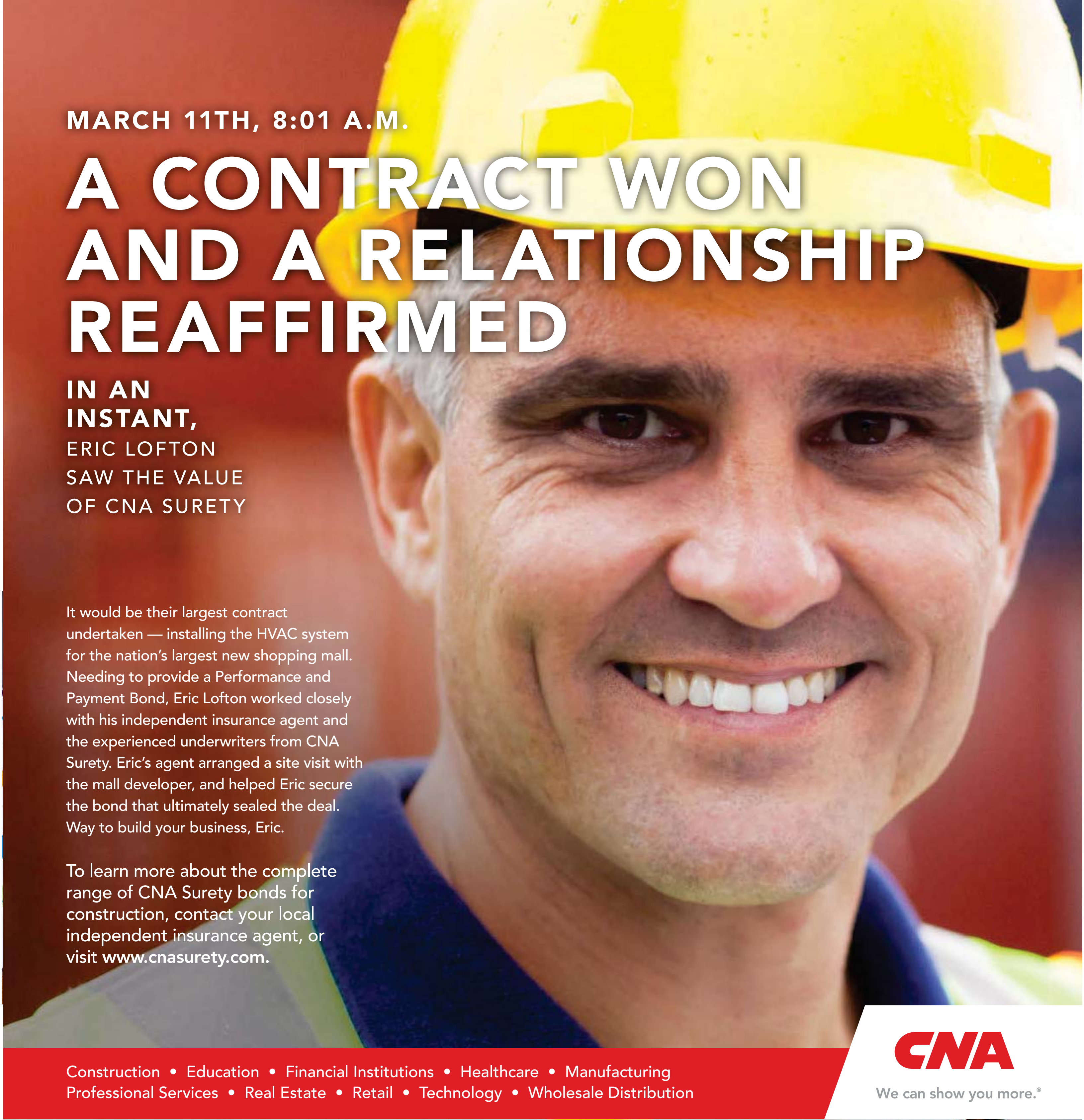
When construction started on the Hoover Dam in 1931, it was one of the largest single construction projects ever undertaken in the United States. The gravity arch dam across the Colorado River cost $49 million, making it one of the nation's most expensive and complex construction projects. The Hoover Dam project marked the first time that surety companies pooled their capacity to provide a co-surety bond. Twenty-four surety companies came together to provide a $5 million bond securing the contract. At the time, it was the largest bond ever written.

Eighty years ago, a $5 million bond needed the participation of nearly every surety in the United States, but today, dozens of sureties can routinely write a $5 million bond on their own. Over the years, the surety marketplace has seen significant changes—the rate of change and capacity requirements are higher today than ever before.

Since the 1930s, the construction marketplace and the surety marketplace have evolved, with

projects growing larger and more complex and the surety requirements growing in parallel. It may be astonishing to some that a bond that required the mobilization of virtually the entire surety industry now falls within the delegated authority of many brokers and agents. For those who have been in the industry for many years, it is more astonishing to see how the market has evolved. Project delivery methods that went from hard bid, fixed priced contracts to design-build are now being bundled as public-private partnerships (P3s).

Projects that just a few years ago topped out at $500 million are now pushing into the billions. The Tappen Zee Bridge replacement project in New York is just one example. First built in the 1950s for $81 million, the new contract for the replacement span currently being built is more than $3 billion.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Twenty years ago, when design-build contracts were becoming more mainstream, the surety industry began debating: How could surety cover design-build risks? Did the underwriters understand the "new" risks they were assuming? At the time, quite a few companies refused to bond design-build contracts. Today, that debate is being replayed with more frequency as owners use new project delivery methods. Traditional hard bid work is being supplanted every day by more complex and challenging delivery methods, such as integrated project delivery (IPD), gap financing and P3s. IPD, an approach based on risk sharing and collaboration, presents challenges to the contractor, owner and surety.

In a risk-sharing approach, where do the traditional bonded risks end and the shared risks begin? While there is no clear answer, sureties are working closely with both contractors and owners on solutions.

In its 2015 Infrastructure Report Card, the American Society of Civil Engineers estimates an annual infrastructure funding gap of $201 billion. The gap arises from the need for continued investment in infrastructure and the lack of federal, state and local funding. P3s are viewed as a way to fund this gap. P3s mobilize private funds—from investors, pension funds and banks—to finance projects that were once funded by the government with tax revenue. The introduction of P3s to the marketplace changes the nature of the owner-contractor relationship. Traditionally a government entity was the project owner, but in a P3, a concessionaire is the owner.

The relationships among the different stakeholders in a P3 project are more numerous and complex than in a traditional project. The concessionaire, the contractor, the banks, the rating agencies and the government all have a financial or public policy interest in the success of a P3. This elicits a new set of challenges for the surety providing performance security for the contractor.

The surety industry has responded by creating innovations targeted at satisfying the needs of the various stakeholders. Traditional performance bonds have been modified to provide short-term liquidity to a P3 project in the event of default. For example, a recent P3 project was bonded using a performance bond with a fixed claims period. As a result, all parties knew when a claims determination was going to be finalized. Although the debate continues on the "right" approach to bonding P3 projects, sureties are not waiting on the sidelines. They are out there innovating.

With regard to capacity, the surety market continues to demonstrate appetite for larger facilities and projects. Just a few years ago, conventional wisdom was that $500 million was the largest surety bond available for a single project—and that required multiple sureties. In the past few years, new capacity has entered the surety market with an eye toward providing surety to mega-projects and the largest contractors. At a time when the costs of construction projects are increasing, surety capacity is keeping pace. Today, surety companies are routinely seeing performance and payment bonds exceed $1 billion. Surety companies are getting these bond deals done a few times a year without fanfare or press. While there clearly is still a limit to surety capacity, the industry is responding with more willingness to provide multi-billion-dollar facilities to companies with the financial strength and capacity to deliver.

While the surety market has evolved since the days of the Hoover Dam, many aspects remain the same. The industry continues to rely on the traditional three "Cs" of character, capacity and capital in underwriting risks, whether it is for a $10 million road builder or a $10 billion multinational engineering company. On the foundation of more than 100 years of industry experience, the surety industry has and will continue to innovate and adapt to the changing needs of customers and the marketplace.

Looking beyond the horizon, more challenges will impact how surety operates: technology, new construction methods and the globalization of the construction industry, to name a few. Sureties are working closely with customers so they can continue to be a relevant and trusted partner in the construction marketplace of tomorrow.

Mike Bond is head of surety for Zurich North America. For more information, email michael.bond@zurich.com.

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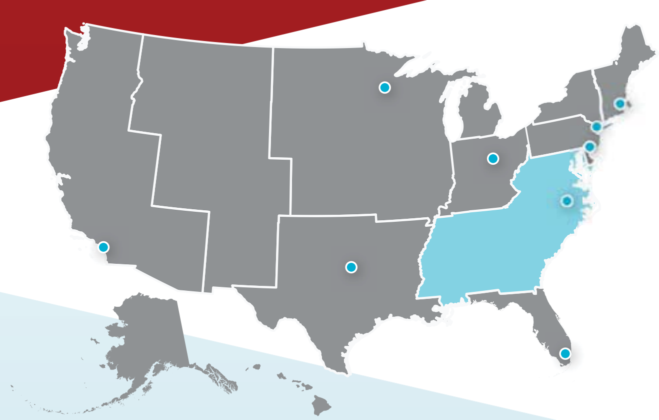
There is an enormous amount of risk in construction. Marsh & McLennan Agency [MMA] and its partner agencies have joined forces to support companies and construction contractors with a dedicated, global network of surety specialists who know the industry. Whether Public, Private or P3; hard bid or design build, domestic or international, we have the ability to help you navigate your potential risks and opportunities.

To learn more about how MMA and its regional partner agencies can help you with Surety Bonding, **visit MMA-MidAtlantic.com.**



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Bonding Legislation in the States and Congress

BY LENORE MAREMA AND DANIEL WANKE

Surety and construction stakeholders have worked hand in hand this year in Congress and at the state level on legislation impacting industry members on several fronts.

> *"Nearly 30 states considered P3 legislation this year.*

Some States Increase Infrastructure Spending
All states were in session in 2015, and for most states this was the first of a two-year session, which means there was a heavy volume of legislation. Most states worked on their fiscal year 2016 budget, which began July 1, 2016. Many states struggled to find more money for infrastructure.

A handful of states (including Georgia, Idaho, Iowa, Nebraska, South Dakota, Utah and Washington) increased their state gas tax rates in 2015 to provide infrastructure funding. Kentucky and North Carolina repealed gas tax cuts that were about to take effect. Maryland, Rhode Island and Vermont had incremental increases in the tax rates this year from legislation in past sessions. In addition, Connecticut, Delaware, Georgia, South Dakota and Washington enacted major infrastructure bills, with the largest $16.1 billion transportation revenue bill passing in Washington.

Public-Private Partnerships (P3s) Are the Key Procurement Issue
Nearly 30 states considered P3 legislation this year. Only Georgia enacted new P3 authority for state and local public works projects. A pending bill in New Jersey would permit the state, as well as local governments, school districts and state colleges, to enter into P3 agreements for public building, structure, road, facility and infrastructure projects. Arkansas revised an existing law that authorizes the Department of Transportation (DOT) to adopt regulations for design-build contracts to permit the DOT to establish regulations to enter into design-build-finance contracts and concession agreements with private partners. California enacted a law authorizing a P3 for a civic center in Long Beach.

Such legislation will be back next year almost by necessity as the states look to complete needed public works projects. P3s are public works contracts just like projects delivered under more traditional methods, and bonding must be required on any construction in a P3. It might seem like this is an issue only for large contractors; yet, states are starting to bundle large numbers of small contracts into a single P3, which will affect contractors of all sizes.

Uptick in Bond Threshold and Bond Waiver Legislation
States looking to balance budgets considered eliminating the protections that surety bonds provide to taxpayers, subcontractors and suppliers with legislation to increase state bond thresholds or waive bonds. In Nevada, a $1 million state bond threshold was rejected, as small contractors working as


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subcontractors would be working on much larger projects without payment protection. In New York, legislation was introduced to raise the state bond threshold from $100,000 to $500,000. The increase was reduced to $200,000 and sent to Gov. Andrew Cuomo, who is considering the impact of doubling the bond threshold.

A bill passed in Arizona that permits the waiver of the performance bond for job order construction services contracts if the amount of construction under the contract does not exceed $500,000 (including change orders). The new law does not permit waiver of the payment bond. The application of the bond waiver is limited to the largest counties and has a 2020 sunset date.

Retainage for Private Construction Contracts Was On the Front Burner

The vast majority of the retainage bills introduced this year dealt with private construction projects. Legislation limiting the amount of retainage on private work was considered in Illinois, Iowa, Maine, Mississippi and Nevada, but most bills were not enacted this year. The governor of Maine vetoed a bill that capped the retainage at 5 percent for private work, and Nevada's new law reduces the retainage on private contracts from up to 10 percent to not more than 5 percent. Legislation pending in Massachusetts provides that provisions in private contracts requiring more than 5 percent retainage would be void and unenforceable for the amount that exceeds 5 percent.

One significant bill on public works projects that is on Gov. Cuomo's desk would prohibit withholding retainage on payments due to suppliers for materials that have been delivered and accepted on public works projects. Sureties are supporting the local contractor groups in seeking a veto.

Congress May Address Contracting Policies by Year's End

The U.S House Rules Committee released the final conference report on the National Defense Authorization Act (NDAA), which is the annual defense policy legislation. Two surety provisions from the federal Construction Coalition's procurement reform legislation were included in the final NDAA legislation in the conference report.

One provision would increase the Small Business Administration's guarantee to sureties in its Preferred Surety bond guarantee program from 70 percent to 90 percent. The second provision would require individual sureties to play by the same rules as any other person or entity that provides collateral to the federal government. Individual sureties would be required to pledge known and reliable assets to back their bonds, and to relinquish control of those pledged assets to the federal contracting officer, who would deposit them in the Federal Reserve system.

These are all simple reforms with no cost to the federal government that will increase small business participation in federal public works projects, and in the case of individual surety bonds, assure that real assets exist to back the payment and performance bonds so subcontractors and suppliers will get paid if the general contractor does not pay them, and taxpayers are not required to pay twice for the work.

The looming question remains whether the president will veto the NDAA as he has threatened because it contains an additional $38 billion in funding over the current caps on defense spending and a prohibition on the transfer of detainees at Guantanamo Bay, which prevents the president from closing the facility.

An extension to the MAP-21 highway act expired Oct. 30, and Congress is considering another six-year extension. The problem remains finding funding for that length of time. All new spending must be offset with increased revenues or cuts in government spending elsewhere. The Senate is looking for $51 billion to fund its bill, and the House may be looking at an even higher amount.

Lenore Marema is vice president of government affairs and Daniel Wanke is manager of regulatory and government affairs for The Surety & Fidelity Association of America. For more information, email lmarema@surety.org *or* dwanke@surety.org.

National and Local Surety Associations Combat Onerous Provisions

BY RICHARD WHITMIRE

While contract provisions should transfer risk to the entity in the best position to bear or mitigate it, some onerous contract and bond provisions improperly allocate risk. This can lead to higher underwriting standards for contractors and higher construction costs for project owners to bear, as these improperly allocated risks are factored into bids and competition is reduced to fewer qualifying contractors.

For the surety industry, onerous terms and conditions impact the top line as well as the bottom line. Refusing bonds means potential lost revenues or loss of the account itself to a competitor. Approving the bonds means accepting potentially higher losses due to the increased exposure and severity from onerous contract terms. For all these reasons, sureties are highly motivated to eliminate or mitigate these risks or, at the very least, contemplate them into their underwriting process.

Instrumental in helping the surety industry with the problems caused by onerous bonds and contract language are The Surety & Fidelity Association of America (SFAA), National Association of Surety Bond Producers and local surety associations across America. Together, they are keeping members informed about onerous contract matters affecting the industry and combating the potential effects of these excessively burdensome obligations by convincing public owners to make changes to their contract documents.

Regional Challenges

The most common types of onerous contract bond issues guarantee long-term warranties, include ratings requirements and demand unreasonable claim response times. Onerous provisions also may vary in frequency from state to state. For example, in California and Pennsylvania, underwriters should watch for very short response times and uncapped consequential damages provisions within school project bond forms. In recent years, some Illinois obligees have required that eligible sureties possess an A+ rating on projects.

Sometimes the language is more difficult to decipher, as evidenced recently by a City of Titusville, Fla., bond form that referenced an incorrect statute. In addressing the multiple problems with the obligee, the Florida Surety Association (FSA) wrote: "[T]he bond form references Florida Statute 224.05; however, there is no such statute. We believe the City means to reference 255.05, which addresses bonds for public projects." Adding to the problems with this bond form, another paragraph identified language that "potentially expands the bond obligations to cover insurance perils." And still another paragraph references uncapped consequential damages. A response from the city on this bond form is still pending.

Clearly, authors of public bond forms may not fully understand the consequences onerous forms have on the contracting procurement process. They often resist industry efforts to modify them and insist upon using them anyway. But changes do happen, particularly when negotiating long-term warranties.

In early 2014, the New England area experienced a high frequency of public school re-roofing projects in which the bid documents required five- to 10-year workmanship warranties. Writing to the obligee and architect, the Surety Association of Massachusetts successfully got owners to reduce contract warranty language down to a more palatable one- or two-year term. Also in early 2014, the FSA convinced the City of Coral Springs, Fla., to issue an addendum reducing the contractor's warranty requirements from 10 years to one. And just this year, the Surety Association of Ohio was able to get a five-year warranty requirement removed entirely from a roofing installer's contract, and five- and 10-year warranties reduced to standard one- or two-year periods on several other roofing contracts.

> *"Contract bond provisions that are fair to all parties encourage open access to public construction projects, promote competition and benefit everyone.*

The South Florida market constantly challenges underwriters with onerous bonds. For years, Miami-Dade County has tied performance and payment bonds to a Florida statute that provides a four-year statute of limitations and a 10-year statute of repose for latent defects. There is good news and bad news on this. The good news is that the FSA, with the help of the SFAA and member companies, negotiated a new bond form deleting reference to the expansive latent defect statute and limiting the surety's liability for all latent defect exposure to five years (as provided by law). The bad news is the county will still occasionally slip the old bond form into bid packets even though the negotiated form has become widely accepted within the industry. Members are advised to remain vigilant.

The SFAA was recently called upon to address another onerous bond form from Miami-Dade County. This time the obligee was the City of Doral. The Doral bond form incorporated consequential damages, expanded liability to include indemnification from negligence and introduced a joint obligee (the county) without reciprocal protection for the surety. Fortunately, in this instance, the city agreed to revise the onerous contract provisions by removing and clarifying the problematic language.

These are only a few examples of the many onerous bond provisions confronting sureties and contractors every day. Although detecting them all is difficult and fixing them is even harder, the consequences are potentially high if they are not dealt with effectively.

Contract bond provisions that are fair to all parties encourage open access to public construction projects, promote competition and benefit everyone. CE

Richard Whitmire is contract underwriting officer for Liberty Mutual Insurance. For more information, email richard.whitmire@libertymutual.com.

Surety Industry Steps Into the Future With Data Standards

BY ROBERT M. COON

For many people who started in the surety business as an underwriter, faxes on thermal paper were cutting edge, computer terminals were CRT monitors with green type on a black background, and the only windows in an office were in the walls. At the time, surety underwriting was a paper-intensive process.

The National Association of Surety Bond Producers (NASBP) Contractor Questionnaire, a four-page document most frequently completed by hand, was the standard form through which a contractor shared basic underwriting information. Work in progress reports, financial statements, bond requests and other information were submitted on paper to an agent, who then sent it to the surety by snail mail. The underwriting process was manual: handwritten analysis on accounting paper, aided by a tape calculator. Contractors waited three to four weeks to learn what kind of program a surety would offer.

Fast forward 30 years, and surety underwriting is a more information-intensive process than ever. While the Internet speeds the transmittal of information, the data remains mostly in PDF documents—essentially a picture of the paper—with manual entry of information often required at each step of the underwriting process. Relative to other data-intensive industries, surety data processing is slow, expensive and has a potentially high error rate.

Several vendors and sureties have introduced proprietary systems to help automate the process. These systems are mainly of value to agencies with low bond volume, needing just one or two surety markets to support their insurance clients. Unfortunately, most of these systems do not communicate with each other, requiring surety agents to learn multiple systems. For a contractor updating information or searching for a new surety, this creates inefficiencies, slows the process and impacts the overall working relationship.

NASBP's Automation and Technology Committee and The Surety & Fidelity Association of America (SFAA) e-Business Advisory Committee recognized the need for a change and formed a task force to address the issue. "When we sat down at the table and asked how we can improve efficiency, we realized one problem was that data was being referred to by various names by different systems," says Greg Davenport, senior vice president of global operations at Liberty Mutual Surety. For example, from program to program, an individual's first name might be designated as firstname, first_name, first-name, name-first, and many other variations.

The task force collaborated with the Association for Cooperative Operations Research and Development (ACORD), an organization established in 1970 to promote standardization of proprietary insurance company forms. Having helped the insurance industry with the development of electronic data standards, ACORD was a natural fit to help the surety industry move toward electronic data transmission. Thus, the ACORD Surety Standard was born and the first form, the

ACORD 501 Report of Execution, was developed, ensuring an efficient transmission of a bond's details from the agent to the surety.

In 2014, the Surety Forms Working Group (SFWG) was formed, consisting of more than 100 surety agents, company representatives and software vendors tasked with continuing to apply the ACORD standard to industry forms. Jenni Waggoner of M.J. Schuetz Insurance Services, Inc. leads the group with the support of Nick Newton of Newton Bonding, representing the NASBP agents. Greg Davenport, one of the pioneers of this effort, and Jason Doll, Liberty Mutual's surety director of international e-business, bring the surety company perspective to the leadership team on behalf of SFAA.

The SFWG's initial focus is on the forms associated with premium transactions and will expand from there. This strategy will encourage early adoption of the ACORD standard by all stakeholders. Toward that goal, a second form, the ACORD 502: Contract Bond Request Form, has been published and will soon be followed by other common surety forms.

The next step, which may be the most interesting to contractors, is the potential adoption of the XBRL (eXtensible Business Reporting Language) standard. This standard for electronically reporting and exchanging financial information is currently used by companies regulated by the Securities and Exchange Commission. The SFWG is exploring the possibility of incorporating the XBRL standard into surety systems, enabling contractors to electronically transmit financial statements, work in progress reports, and other financial data directly from their CPA or financial software to their agent and surety.

The NASBP's and SFAA's promotion of these data standards will enhance the surety industry's efficiency, productivity and quality—helping improve response times and the overall level of service and support provided to contractors. CE

Robert M. Coon is vice president of surety for Scott Insurance, as well as president of the Piedmont Chapter of the Construction Financial Management Association and chair of the NASBP Automation and Technology Committee. For more information, call (336) 273-6599.

Understanding Indemnity

BY STEVE DORENKAMP

Understanding indemnity agreements is important for any contractor performing bonded work. Indemnity plays a key role in protecting taxpayer money and the project owner from poorly performed work; making sure subcontractors and suppliers get paid; and perhaps most importantly, keeping the premiums paid for surety protection very low. Without indemnity, sureties likely would charge much more for bonds.

Although the surety is indemnified by the contractor under law, the General Indemnity Agreement (GIA) not only puts this in writing, but it also allows owners of the company, or other individuals, to help the contractor qualify for surety bonds or larger bonds than the contractor would get alone.

Personal indemnity allows the surety to consider the owner's financial situation in underwriting the bonds and helps assure the surety that funds will not be diverted from the bonded project to unbonded projects. The GIA also spells out how claims will be handled. Contractors and their agents should check the claims handling reputation of any surety company and build relationships with the good ones.

The Basics

A surety indemnity agreement is an agreement between the contractor and the surety, and other individuals and the surety, stating the surety company will be indemnified if it pays out a claim on the bond, including legal fees.

In simple terms: A surety company issues a bond that guarantees the performance of a contractor and guarantees the contractor will pay subcontractors and suppliers. But, the contractor remains liable for these obligations. If the surety company must perform its duty and pay claims or replace the contractor, the contractor is required to reimburse the surety company for the full amount of the claims paid.

Some experts call surety bonding "borrowing the balance sheet of the surety company for the purpose of a contract."

Why Indemnify?

The indemnity agreement is a clear and unambiguous way to define the obligations of the contractor and indemnitors. The cost of a bond is a very low price to pay for the surety to step up and promise to cover the entire cost of a multimillion-dollar project if the contractor doesn't perform. This is possible because the surety has underwritten the case to make sure the construction company and any indemnitors have the wherewithal to repay the surety if the need arises. An indemnity agreement is good for the contractors that can obtain bonds larger than if there were no indemnity, and it's good for the owners that pay less for the bonds.

Negotiate Terms or As-Is

Construction attorneys often are concerned the indemnity agreement might allow the surety to step in at any time and take over a project, including the contract funds. This would never be in the surety's best interest. Lawyers also sometimes are concerned that the surety has the power to pay claims without consulting the contractor, and therefore, they try to negotiate the terms of the indemnity agreement, asking for conditions on the indemnity such as, "in case of default" or "in case of termination."

Again, this wouldn't be in the interest of the surety; a surety always needs to gather information about any claim. In special circumstances, surety companies will consider negotiating some of the language of the GIA with financially strong contractors that have good track records for meeting their obligations.

Sureties prefer the agreement to be signed as-is, allowing them to fully perform their duties. The bond principal and any indemnitors have to understand that the surety cannot be their rubber stamp if a claim is made. Just as the existence of the bonds helped the principal qualify for the contract, the existence of the indemnity agreement helped the principal qualify for the bonds.

No one, least of all the surety, wants to see the contractor fail. The surety wants the contractor to be successful and meet its obligations.

Communication Is the Key

Communication is how all parties can work together for a win-win. No surety should unreasonably pay claims without first communicating with the contractor and the contractor's agent. No surety should take over a project from a contractor and incur the costs to complete it successfully if it can stop problems while they are still manageable.

A qualified surety company will always work hard to help solve any problems and communicate with all parties throughout the project. The GIA helps set out the process for everyone to stand behind the contractor and the work.

Steve Dorenkamp is vice president of claims and claims manager for Merchants Bonding Company. For more information, email claims@merchantsbonding.com.

Cyber Risk: Three Key Questions Contractors Should Ask

BY KEN GOLDSTEIN

Using everything from BIM software to mobile devices, workers in the field and managers in the office are sharing information with ease, but there's a downside. More information connections can create more risk, especially if sensitive information is involved.

- A construction firm discovers that intruders have accessed its computer network, but the extent of the breach is unclear.
- An employee's tablet disappears from a jobsite; customers' financial information is stolen from the device and sold.
- Cyber thieves hack into a contractor's systems as a sophisticated first step in accessing a business partner's information.

Cyber attacks are on the rise, both in frequency and in the cost to remediate the consequences. The Ponemon Institute's 2015 Cost of Data Breach Study reported that the average total cost of a data breach in the United States is $6.5 million. Criminal or malicious attacks are the most frequent cause of a breach—and also the most costly.

A breach's impact can branch out in many directions. For instance, expenses could include the cost of notifying customers of a breach and providing them with credit monitoring services. Less often contemplated is the possibility that a network shutdown could disrupt job scheduling or in some cases bring the business to a halt for days or even weeks.

Even if no sensitive information was accessed during a data breach, the forensic costs associated with investigating and making that determination can be significant. The Ponemon study found that average detection and escalation costs for a breach (such as forensics and crisis team expenses) jumped from $420,000 in 2014 to $610,000 in 2015.

That's just the effect on the firm. What about the potential impact to customers and business partners? If a breach to the business causes them to lose income or compromises their data, they are likely to file lawsuits alleging financial injury or privacy injury.

Another potential consequence of a data breach is regulatory costs. If the federal or state government


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investigates the firm to determine whether it has complied with security requirements, the business could face investigative costs as well as fines or penalties.

If the firm collects, stores or transmits private information, it has a cyber security exposure. Fortunately, going on the offensive with three key questions enables companies to address many potential issues before a breach occurs.

1. How Secure Are Information Systems?

The first step is to understand and address potential system weaknesses before cyber criminals find them. Penetration testing is an important tool for doing so.

Penetration testing involves bringing in experts who will scan the computer system, looking for security weaknesses that could potentially be exploited. This testing also typically attempts to exploit those weaknesses to determine the potential for a breach. Because improperly performed penetration testing can be damaging to a system, it's important to hire an experienced firm with a proven track record. And because threats change so quickly, repeat this testing annually.

2. How Can the Chances of a Data Breach Be Minimized?

A written information security policy essentially is a business plan to help prevent a data breach. The security policy should be tailored to the business and should address:

- roles and responsibilities of those who are accountable for information security (including both internal and external resources);
- types of information the business deals with and ways to protect it;
- expectations regarding how employees should store and disseminate information, as well as information on how those expectations will be enforced; and
- requirements for mobile devices (e.g., laptops, smartphones and portable hard drives), including encryption and the ability to wipe a device clean if lost or stolen.

Average cost of a data breach

2014: $420,000

2015: $610,000

The information security policy is only helpful if it's followed consistently. Employee training can be challenging if workers are typically spread among different jobsites, but it's critical to ensuring implementation takes place.

3. How Can the Impact of a Breach Be Mitigated?

If a breach occurs, time is of the essence. Creating a detailed incident response plan can help minimize the disruption of the breach, and in turn limit first-party expenses, legal ramifications, regulatory fines and penalties, and potential reputational damage. The plan should include:

- the names and contact information of those to be notified if a breach is discovered (also known as the incident response team);
- the specific information to be shared with the incident response team;
- the factors to weigh when determining the severity of the breach and the response;
- the steps to take to restore affected systems; and
- the process for documenting the incident.

The incident response team should include both internal resources and external firms, such as public relations and legal professionals. Update the plan annually to keep contact and other information as accurate as possible.

This step can really pay off. According to the Ponemon Institute, an incident response team can reduce the per-capita cost of a data breach from $217 to $193.20.

Insurance is another key element of the equation. Cyber policies aren't standardized, so review coverage terms carefully with an insurance agent or broker. Look for an insurance carrier with experience in both the construction industry and in cyber insurance, as well as a commitment to helping minimize the possibility of a loss. Some insurers offer loss prevention and reimbursement for certain measures to help companies better prepare for cyber attacks. CE

Ken Goldstein is a vice president of global cyber security for the Chubb Group of Insurance Companies. For more information, email goldstek@chubb.com.

Prevent and Protect Against Employee Theft

BY ROBERT DUKE

The risk of theft—whether by one's own employees or outsiders, in person or virtually—is an exposure all contractors should take seriously. In fact, from 2009 to 2013, fidelity and crime bonds written for contractors generated about $61 million in premium and had incurred losses of $48 million for a 79 percent five-year loss ratio, according to data from The Surety & Fidelity Association of America (SFAA).

Common employee theft schemes include taking tools and materials from jobsites, creating fictitious vendor accounts, stealing company checks, and making unauthorized payments by altering the check and forging the signature.

The types of personnel that account for the most employee theft incidents include bookkeepers, project managers and executives. This makes sense considering these are the people with the greatest access to the company's assets.

Fraudulent schemes ultimately are discovered in a variety of ways. A bank may provide the contractor notice of unusual activity in the account. Regular audits frequently expose unauthorized transactions. At times, the crooked employee may act strangely, such as a bookkeeper exercising a high level of secrecy over the company records or never taking a vacation. Very often, a scheme is unwound and detected when the employee is not around to ensure that the fraudulent activity is not detected, particularly when the bookkeeping duties are not segregated, such as making vendor payments and reconciling the bank statement.

For example, a scheme could involve a bookkeeper writing himself a $1,000 check at the same time he writes a check to a legitimate vendor for $10,000. He then records in the ledger his check as void and the vendor's check in the amount of $11,000. At the end of the month, when he receives the bank statement and the cancelled checks, he simply destroys the check made out to himself. If the bookkeeper were on vacation, he would lose the opportunity to cover his tracks.

Contractors must be aware of the risk of employee theft and establish strong internal controls as a first line of defense. Some prudent controls include segregating critical duties (such as vendor payments and bank statement reconciliation), utilizing regular and unscheduled audits, providing employee training and establishing reasonable employee screening practices (e.g., background checks and reference checks).

Contractors also should give high priority to computer security, such as controlling access to the company's computer systems and implementing intrusion prevention and detection software. Firms should be aware of their vulnerability to not only employee theft, but also the risk of theft by outsiders.

Technology is helping facilitate theft. For example, a growing scheme uses email to impersonate an employee or vendor and induce a company to make a payment (see "Cyber-Phishing in the Construction C-Suite" on page 104). The fraudster impersonates a vendor, customer or employee of the insured, and contacts the insured requesting a wire transfer of funds. Then, based on this phony information, a legitimate employee of the insured contacts the bank to place the order for a wire transfer. Thus, the instruction sent from the insured to the bank is legitimate, as it is sent by a legitimate employee intending to do so. However, the employee was fraudulently induced into contacting the bank and making the order for the wire transfer.

The exposure for such scams can be significant. According to the Federal Bureau of Investigation's Internet Crime Complaint Center, such scams resulted in losses totaling $214,972,503 between October 2013 and December 2014.

In addition to establishing strong internal controls, contractors should obtain a crime policy that insures against theft losses in cases when the internal controls are defeated. For example, the SFAA Crime Protection Policy provides the following coverages:

- employee dishonesty;
- forgery;
- theft/robbery (inside and outside);
- computer fraud;
- counterfeit currency;
- loss of client's property resulting from employee dishonesty;
- fraudulent wire transfers; and
- fraudulently induced wire transfers.

Robert Duke is director of underwriting and corporate counsel for The Surety & Fidelity Association of America. For more information, email rduke@sfaa.org.

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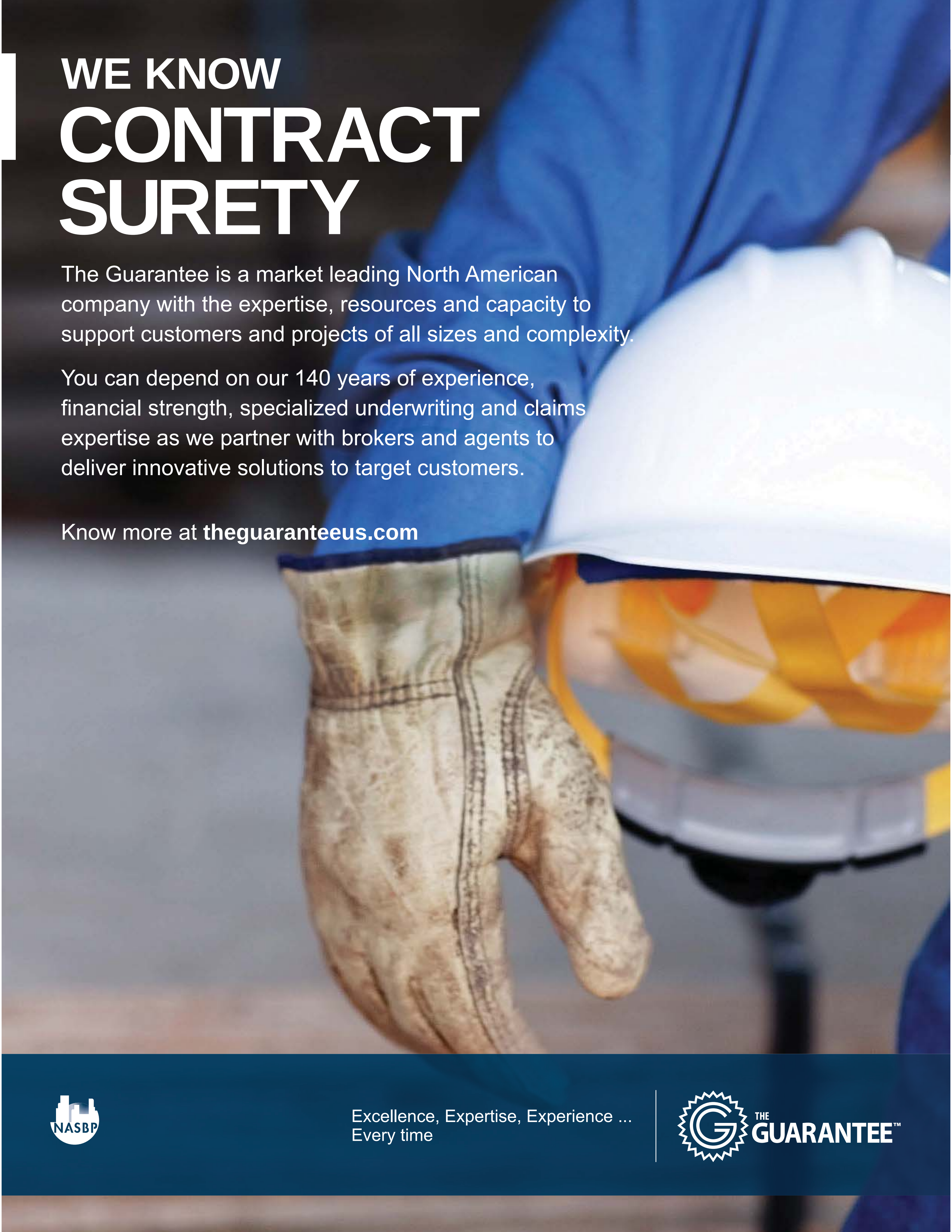
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