CONSTRUCTION EXECUTIVE

14TH ANNUAL

CONTRACTORS' GUIDE TO SURETY BONDING

PUBLISHED IN ASSOCIATION WITH:

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14th Annual Contractors' GUIDE TO SURETY BONDING

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Contractors' Guide to Surety Bonding is a special section of *Construction Executive*, published by Associated Builders and Contractors Services Corp.

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Sureties Hungry for Business Across Market Sizes

BY KATE WOERHEIDE

Construction Executive surveyed top leaders in the surety bonding industry to create a big-picture view of the current state of the market. Overall, the news is positive for contractors. Experts say construction and surety market cycles have been strong, creating increased competition.

"Like so many markets, surety moves in cycles. Today's profitability generates excess capacity, and this excess capacity will breed losses. These losses typically weed out some players, reduce industry capacity and may create an environment, as we've seen before, where too much demand chases too little supply," says Ross Fisher, board chair, Surety & Fidelity Association of America (SFAA) and senior vice president of The Hartford's large commercial businesses.

"Whether it is a small or mega-sized contractor, capacity looks to remain extremely strong again in the year ahead, and sureties continue to be hungry for more business. This is truly a buyer's market," says Michael J. Mitchell, vice chairman of The Graham Company.

Adds Scott Paice, vice president and head of surety for FCCI Insurance Group: "Everyone from large carriers to newer entrants are vying for your business. If you are new to surety, there has never been a better time to establish your surety credit."

In this current cycle, surety losses have not been an issue; in fact, sureties have been profitable. Given the high competition, it is important that good underwriting discipline and terms are maintained.

SMALL

The surety market for small contractors is ripe—with both appetite and availability, leading to increased competition among carriers—making it easier for small contractors to obtain surety credit. "Express" underwriting programs have become increasingly popular with some companies writing single bonds up to $1 million based on limited underwriting information," Paice says.

Melissa Current, assistant vice president of surety and fidelity for First Insurance Company of Hawaii, Ltd., adds that "while there have been multiple mergers within, and exits from, the surety industry during the last decade, availability of surety credit has not waned."

In keeping with the overall trend, surety losses in the small market segment have not been an issue. "Surety losses have remained well within the 20 percent industry standard despite the recent global economic crisis," Current says.

However, Steven Swartz, president and CEO of South Coast Surety warns, "As competition for market share continues, losses may start to grow." In addition, "subcontractors continue to feel the pressure as project owners and general contractors shift more responsibility down to their level. Subcontractors need to be on the lookout for onerous contract provisions and should look to their surety and trusted advisors for guidance," Paice says.

JD Weisbrot, president for JW Surety Bonds, comments that the "surety industry is cyclical in nature, and the industry has enjoyed profitable underwriting for the past 12 years. This has meant new bond companies entering the surety space, allowing for an over-saturation in capacity and availability."

MEDIUM

"The number of sureties operating in the middle market segment is the highest it has ever been," says William Waters, vice president of contract underwriting for CNA Surety.

The surety market for contractors performing projects under $100 million is very competitive, adds Josh Penwell, vice president of contract underwriting for Merchants Bonding Company. "We are seeing an adequate amount of surety capacity in this market segment for properly capitalized and well-managed contractors," he says.

Adds Antonio C. Albanese, vice president and head of surety for Nationwide: "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."

Lynne W. Cook, senior vice president for Early, Cassidy & Schilling, Inc. and president of the National Association of Surety Bond Producers explains, "The middle sector currently is one of the most competitive. Increased capacity from within the surety community is one major reason for this situation. Because the return on capital from surety has been higher than property and casualty insurance lines, some insurance companies that previously had not been in the surety market entered the surety business, and others that exited the surety market decided to return."

Much like the small market segment, the middle market has not seen significant loss activity. "Given the increased pressure for premium production now that the economy is recovering, the marketplace will most likely see an erosion of underwriting discipline, which will lead to greater loss levels in the future," says Alan P. Pavlic, president and COO of Old Republic Surety Company. "However, during the economic slowdown, some sureties remained fairly disciplined with underwriting."

In addition, "efforts by sureties and agents to continually educate contractors about the benefits of managing backlog, bonding back significant subcontractors and identifying onerous contract terms continues to have a positive impact on results," says Michael P. Cifone, senior vice president of surety underwriting for Hudson Insurance Group. "Mitigating risk for the contractor involves not only identifying and minimizing risks in the execution of work, but also understanding the terms of the contract and selecting the right owners to work for."

LARGE

The large market sector has seen new and existing sureties continuing to provide substantial capacity and may be the most competitive of all four market sectors. Fisher of The Hartford and SFAA offers three reasons why: "First, those sureties serving the 'mega' contractor space easily serve this 'large' space as well. Second, sureties that are new to the market or serving the "middle" space often stretch into the large arena.

"And finally, the number of contractors operating within the large range is decreasing due to construction industry-wide consolidation that tends to make these contractors sellers rather than buyers."

MEGA

Fewer sureties participate in the mega market segment given the high-capacity requirements. "Mega contractors with a strong credit profile are enjoying very strong surety industry support. Project sizes are bigger than ever, so this surety capacity is a key advantage for firms to acquire new projects," says Robert Murray, Zurich's executive vice president and head of surety.

Dillon Rosenhaumer, construction practice leader for INSURICA, adds that greater "competition is creating availability" in this market segment.

"Overall surety industry loss experience continues to be lower than historical norms, largely driven by excellent results in the mega contracting segment," Murray says. "Contractors in this segment face challenging projects and demanding owners, but relentless focus on cost control and risk mitigation has produced favorable results."

Kate Woerheide is communications manager of The Surety & Fidelity Association of America, Washington, D.C. For more information, email kwoerheide@surety.org.

SPECIAL SECTION:
CONTRACTORS' GUIDE TO SURETY BONDING

The **Executive Insights** series is compiled by Donald Berry, national sales manager for *Construction Executive.* For more information on participating in a future Q&A, email *dberry@magazinexperts.com.*

Executive Insights

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

ROSS FISHER
BOARD CHAIR
Surety & Fidelity Association of America

SENIOR VICE PRESIDENT
The Hartford – Large Commercial Businesses

The best advice for contractors is to work with their underwriter and agent in an open and collaborative environment. Yes, they will need to build their balance sheet to support their work program, but this can be done over time and in the context of a well-communicated plan. Likewise, contractors should share their plans for building their execution capacity, demonstrate proven talent and systems, and lay out their roadmap for building their organization's muscle. Finally, contractors can demonstrate their positive character by making these commitments, by treating clients, other contractors, vendors and all of their people well, and by communicating—perhaps over-communicating—with their surety underwriter and agent.

Surety underwriters really want to provide bonds. Good surety underwriters know that construction is not a linear business and that things don't just happen overnight. Contractors can help their surety to help them by becoming their most transparent client.

LYNNE W. COOK
SENIOR VICE PRESIDENT
Early, Cassidy & Schilling, Inc.

PRESIDENT-ELECT
National Association of Surety Bond Producers

The contractor should be prepared to explain how it plans to accomplish its business plan. A bond producer will work with the contractor to maintain and enhance its surety program, acting at all times as a trusted advisor, including providing feedback on the operational and financial steps necessary to improve its surety program.

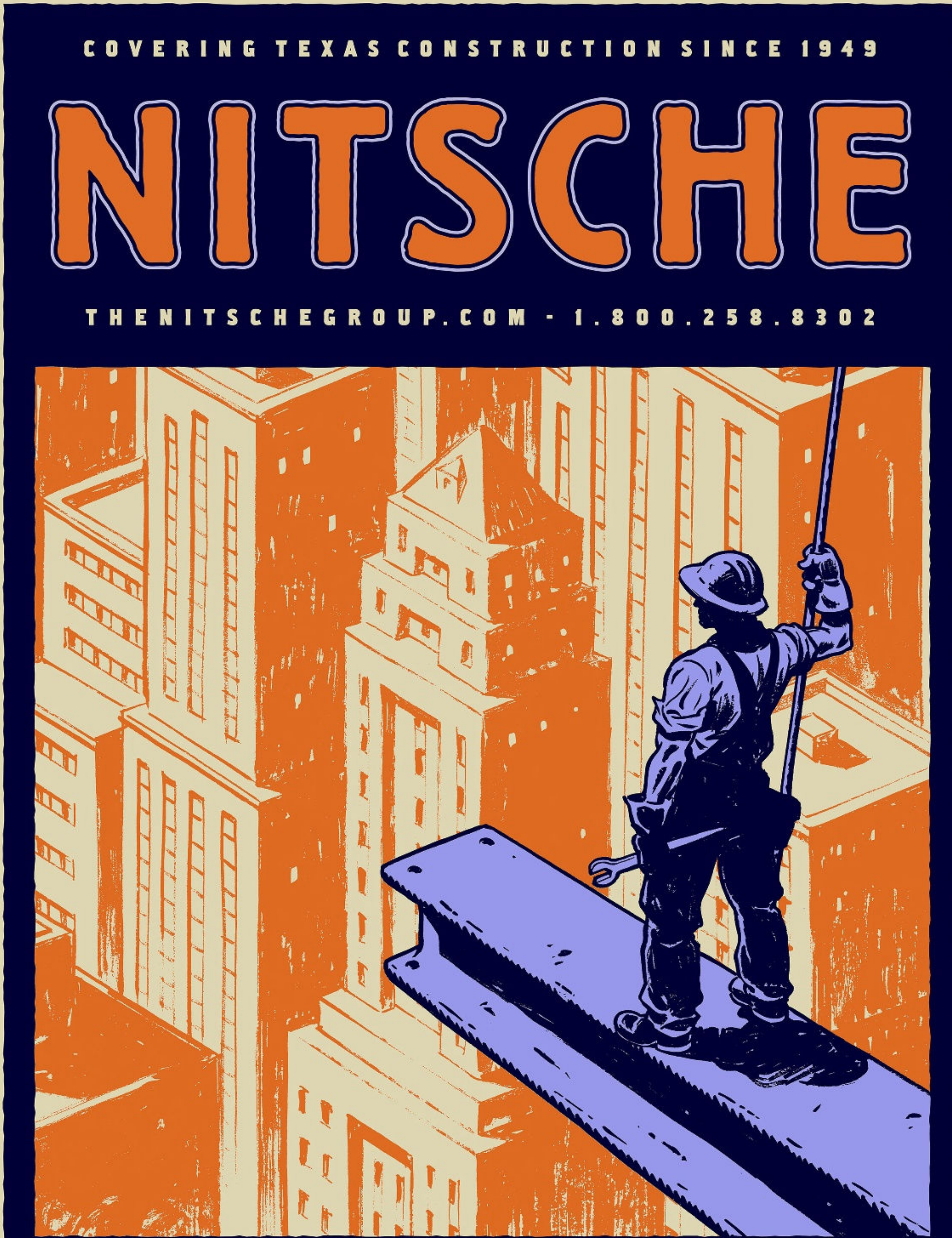
Examples of operational steps that are beneficial include using an internal accounting system that manages the contractor's type of work and revenues, maintaining the accuracy and timeliness of the internal financial statements and work in progress reports, ensuring the accuracy of overhead and indirect cost estimates, and developing a system that manages the change order process.

Examples of financial steps that are beneficial include reducing overall debt, retaining profits, billing all costs and estimated profits in a timely manner, collecting receivables within 90 days and adding capital to the business. Retaining net income to support growth as opposed to distributing the money is an effective way to improve bonding capacity. Improving cash flow also is helpful.

ANTONIO C. ALBANESE
VICE PRESIDENT - HEAD OF SURETY
Nationwide

A contractor can take its bonding capacity to the next level by demonstrating proven success in job performance and operations at current levels. A second factor is profit retention from current projects. This provides growth in the firm's liquidity and net worth to provide financial strength and an expansion cushion. There also should be a detailed business plan with a controlled pace of expansion for added capacity.

How does a surety understand and analyze a contractor's success? The key is the use of reliable internal accounting systems and working with a professional construction-oriented CPA to verify that success via independent financial reporting (e.g., providing financial statements on a cost-to-cost percentage of completion method of accounting with all relevant schedules of open and closed projects). All of this provides the underwriter with a clear picture of the contractor's financial health and assurance the bonding capacity the underwriter has extended is progressing well. With this comfort, the underwriter can provide additional capacity knowing the contractor has the proper tools in place to grow.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Executive Insights

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

STEVEN SWARTZ
PRESIDENT/CEO
South Coast Surety

You need to have shown the ability to successfully manage the bonded work in your current program with good profit margins that don't fade. And you need to have a good financial presentation prepared that reflects the profit stream from those jobs and also displays your continued efforts to retain and grow the company working capital and net worth.

But, it is your professional surety agent that can help guide your firm in reaching larger work program goals. Your surety agent should be communicating regularly with your CPA, who is experienced in generating construction accounting financial statements in a form and format preferred by surety underwriters. Your surety agent should be working hand in hand with you and your staff as you start to focus on future jobs you intend to pursue.

Successful construction executives align with a strong independent advisory team of an experienced construction attorney, accounting firm and professional surety agent. When added to your own staff, this team provides the insight and support to make that path to larger bonded contracts seem easy.

JD WEISBROT
PRESIDENT
JW Surety Bonds

The main factors that allow larger surety support for contractors are a quality financial presentation, open communication with your agent and surety, and strong support from your banker/lender. The financial presentation should come from a CPA who is familiar with the nuances of construction accounting. A presentation done on a percentage of completion basis with complete notes, disclosures and work schedules will give both your bank and surety the best insight into the company's health.

We advise our contractors to have the CPA draft a year-end financial statement and then openly discuss their goals with their surety agent on how to properly deploy that net profit at year-end. It's often wise to keep some, if not all, of the net profits on the balance sheet so the surety can offer enhanced support for future projects.

Lastly, sureties are always comforted by a contractor that has with a strong bank line established in case of a cash crunch, but simultaneously can get concerned if a contractor is consistently using most or all of its bank line on a regular basis.

DILLON ROSENHAMER
CONSTRUCTION PRACTICE LEADER
INSURICA

To take bonding capacity to the next level, a contractor needs to go beyond capital, character and capacity. When these have been satisfied, a surety can derive a work program.

To increase bonding capacity and work program size:

- Improve the quality of financial reports. Upgrade from in-house accrual to a review, or review to an audit. Keep an up-to-date WIP with cost to complete, percentage of completion, gross profit left in the backlog and over/under-billings.
- Reinvest retained earnings and limit bonuses and dividends. Rather than taking an $80,000 bonus at year-end, leaving the money in the company could result in an additional $800,000 in bonding capacity.
- Turn receivables over more efficiently.
- Remember that cash is king. The more invested an owner is in his or her operation, the more comfortable a surety is increasing capacity.

Partnering with your agent, accounting firm and surety helps the surety gauge the stability of a contractor's future and builds confidence at bid time.

Executive Insights

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

WILLIAM WATERS
VICE PRESIDENT - CONTRACT UNDERWRITING
CNA Surety

The old saying that "cash is king" is especially true during economic recovery. Revenue growth consumes cash and effective cash management starts with collecting your receivables. Accounts receivable typically make up most of a contractor's current assets and your surety and banker normally discount any receivables older than 90 days from their calculation of working capital.

Your opportunity to convert receivables into cash in a timely fashion starts with negotiating favorable payments terms. However, your relationship with the owner and their track record for timely payment are often times more important than what is written into the contract. This is especially true with public owners because contract terms are frequently non-negotiable and some have a history of slow payment.

Good contract terms and an owner who pays in a timely fashion are just the first steps. You need to have disciplined billing processes and accountability in the field and main office for the collection of accounts receivable.

JOSH PENWELL
VICE PRESIDENT - CONTRACT UNDERWRITING
Merchants Bonding Company

A critical component of a construction company's bondability is employing best practices for cash flow management. As the economy recovers, the danger of default becomes even more prevalent as companies ramp up operations.

Company leaders should practice regular reviews of cash flow management techniques to ensure the long-term success of the company regardless of the ebb and flow of the economy.

A disciplined approach to keeping overhead from outpacing revenue, regular reviews of business areas that can tie up cash and maintaining the ability to maximize cash on hand are successful ways to avoid surety losses. Surety losses are often the result of cash flow failures.

Strong banking relationships are also a key component of a company's cash flow picture and are viewed favorably by the surety.

JIM BLY
MANAGING DIRECTOR
Alliant

Pay if paid clauses are not possible with many material and equipment vendors. so even the most profitable subcontractors occasionally may need to tap into their bank line of credit. Astute bankers will allow bonded receivables to be included in the borrowing base calculation if they have entered into an intercreditor agreement with the contractor's surety. The intercreditor agreement should allow the bank the first right to bonded receivables up until the time of a surety default.

Once a default occurs, the surety is given its equitable subrogation right to all bonded proceeds, including the right to cross-apply bonded job proceeds from one bonded job to the next. This makes the surety a perfected security lender when a formal default scenario occurs and allows the surety to be more flexible in providing bonding capacity, while at the same time providing the bank with a higher collateral base. Banks are allowed to sweep the bonded job proceeds up until the time of the surety default. The surety may be given a short claw-back period of a few days to allow collection on recent bonded A/R that the bank swept.


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Executive Insights

How does character impact a contractor's bondability?

MELISSA CURRENT
ASSISTANT VICE PRESIDENT - SURETY AND FIDELITY
First Insurance Co. of Hawaii, LTD

The surety relationship is essentially a business partnership based on mutual trust and respect. Each party must demonstrate strong character. The surety does this by remaining consistent in support of the contractor's surety credit program and providing input as needed. The contractor does this by following through on commitments made to the surety and keeping the surety informed of operational matters.

The surety agent/producer is an integral part of the business partnership, and must exhibit the same strength of character by providing timely, complete and accurate information, as well as experienced, actionable counsel.

A contractor's character is the deciding factor in choosing to support a surety credit program once it has been established that the capacity and capital of the contractor warrant the size and scope of the program desired. Once the surety relationship is in place, the contractor's character drives the ability or inability of the surety to accommodate stretch or out-of-the-ordinary bond requests.

SCOTT PAICE
VICE PRESIDENT - HEAD OF SURETY
FCCI Insurance Group

Sureties are more willing to overlook financial issues and focus on character and experience during a soft market in order to pick up new business or stretch out an existing account. Character references are key when considering start-up and spin-off operations or accounts that are still recovering from the recession.

The surety bond producer is the first line of character reference and trust. Independent agents represent a number of different surety companies and build these relationships over time based on confidence and experience. An underwriter can quickly gain a comfort level with a new contractor account if the agent has handled the account for a while and can vouch for the firm's integrity, track record and expertise.

Another important element is having an annual meeting with the surety and bond producer. These meetings can go a long way in demonstrating the "people behind the paper" for all parties involved. Character is apparent in the entire team that you surround yourself with, including your CPA, banker, attorney and employees.

CARL CASTELLANO
VICE PRESIDENT - CONTRACT SURETY & CHIEF RISK OFFICER
Philadelphia Insurance Companies

Character is the key component of our business, best portrayed by two real-life experiences.

ABC Mechanical was a 20-year surety client when an obligee constructing a high-profile project demanded ABC to accelerate, significantly expand it scope of work and settle up later. Our indemnitor immediately called us to outline a recovery plan and request financial assistance. The indemnitor finished the project on time. The indemnitor cashed out of his IRAs, remortgaged his personal residence and transferred these funds to us, which left us with a modest loss. We then agreed with the indemnitor to continue providing surety, sharing a portion of net income, and we were ultimately repaid our loss. Without his exemplary character, the indemnitor would not have been able to continue in business and we would have suffered a loss.

Conversely, XYZ Painting enjoyed significant working capital and net worth, which left our country when XYZ encountered financial difficulty—no more surety credit and no more business.

Executive Insights

How does character impact a contractor's bondability?

BART DAVIS
VICE PRESIDENT - CONTRACT SURETY
RLI Surety

Evaluating character is one of the most difficult quantitative measures used by surety underwriters. The continuous demonstration of good character can be a differentiator for a contractor's business. In its most simple form, sureties want to support contractors that can be trusted to deal fairly with all parties involved in a construction project.

Surety underwriters can gain some insight about a contractor's character by evaluating their relationships with key suppliers and subcontractors. This can extend well beyond how well they pay their bills and into how well they successfully negotiate a dispute.

By becoming known as a problem solver, contractors can separate themselves from their competitors. The frequency of disputes or litigation can be used as an example. It is quite appropriate to be firm in some situations, but demonstrating an ability to find equitable resolutions to challenges that arise during the course of a project can build loyalty to a contractor's business.

MICHAEL P. CIFONE
SENIOR VICE PRESIDENT - SURETY UNDERWRITING
Hudson Insurance Group

A surety is continually evaluating the financial strength and character of the contractors to which it provides bonds. Character is by far one of the most important factors in determining a contractor's bondability.

Financial statements will only take a contractor so far. The ability to develop and execute a long-term growth plan requires a strong management team and support of the surety. A contractor that builds a relationship with the surety based on trust and open communication will possess the tools to prosper.

A solid character and leadership qualities are also essential to attracting and retaining quality employees to successfully complete a project on time and within budget. Behind most successful contractors is consistent, quality work that is performed as promised.

By nature, contractors are risk-takers, and contractors with strong character may retain their surety support when times get tough. When risks are taken with honesty and integrity at the core of every decision, the risks are manageable and a surety is more likely to remain a solid partner.

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 inherent to determining bondability. If a surety does not have a good feeling about supporting the contractor, then that feeling carries more weight 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 instinctively want to support them, but it all starts with having a strong character.


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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.
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Executive Insights

How does character impact a contractor's bondability?

HENRY W. NOZKO, JR.
PRESIDENT
ACSTAR Insurance Company

Financial strength and experience are important elements of underwriting, but questionable character makes the surety feel like it is sitting on a two-legged stool. A financial statement is just a snapshot of how things stand at a given time. However, a principal has knowledge about the company and business conditions that will affect a financial statement. Misrepresenting the profitability on unbilled work could significantly change the stated value of a given enterprise.

Character will either maximize or diminish the level of bonding offered to a contractor. Delivering on what has been promised is one way of conveying a high level of character. When promoting your organization's attributes, also talk about challenges and areas of weakness. Exceeding projections will raise a surety's confidence, while missing projections has a punishing effect on the perception of character.

Sureties are unlike banks, where most of the flexibility for lenders is regulated out. Sureties have an unfettered, wide range of support in hand. Character can be the factor that moves the needle up the highest on the range of possibilities.

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

ALAN P. PAVLIC
PRESIDENT/COO
Old Republic Surety Company

Generally, sureties don't want to bond a joint venture that does not meet the set-aside requirements (affiliation with an unqualified partner). If the U.S. Small Business Administration (SBA) or U.S. Department of Veterans Affairs (VA) would qualify and approve joint ventures upfront, that would eliminate the surety's concerns about potential disqualification. The rules now are vague. In analyzing a joint venture arrangement, a surety can only guess what the SBA or VA would say if they were to scrutinize the joint venture. Consequently, surety companies err on the side of caution, and a joint venture that does in fact qualify may not be approved.

It may be more helpful to small businesses for government entities to allow contracts in small increments, which would not necessarily require joint ventures to be formed. Getting involved in a joint venture can present various risks to small, emerging contractors that would not be presented working on their own. It is more advantageous for a small contractor to work and grow independently whenever possible.

ROBERT MURRAY
EXECUTIVE VICE PRESIDENT,
HEAD OF SURETY
Zurich

We anticipate seeing many small businesses and large contractors taking advantage of the recently expanded SBA mentor-protégé program

Sureties may expect large contractors to seek support for bonds for SBA joint ventures (JVs), relying primarily on its own indemnity and financial strength. The reality is that the consequences of protégé default will fall more heavily on the mentor, even though the mentor will not have the direct control to manage the project.

Early surety involvement can help mentors evaluate how participation will impact risk exposure. The SBA regulations are complex, and non-compliance can have significant implications for the mentor and protégé, including penalties and financial losses. An experienced surety may be able to share past experiences and make recommendations about consulting qualified legal advisors before proceeding with SBA JV programs. CE

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Vice President, Head of Surety
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Antonio Albanese

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.

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

When you work with us, you know you are working with a strong and stable carrier. Nationwide is a Fortune 100 company that the U.S. Treasury listed and approved with a T-listing in excess of $1.1 billion[1], and it is one of the largest in the industry. Add to that an A.M. Best Rating of A+ (Superior), FSC XV1[2] and an S&P A+ rating[3], and you can be sure you're working with one of the most financially stable companies in the industry.

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COMPANY HIGHLIGHTS

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

1. Affirmed April 2016
2. Nationwide Mutual Insurance Company, March 2015, https://www.fiscal.treasury.gov.
3. Affirmed April 2016

OLD REPUBLIC SURETY

A Year of Celebration and Growth

We have a lot to celebrate at Old Republic Surety Company (ORSC). This has been another banner year for written contract surety premium; in addition, we've been celebrating with our appointed independent agents and our employees in this, our 30th year of Rockin' Bonds. More cause for celebration is the fact that we've opened new contract offices in Albany, N.Y., Cincinnati, Baton Rouge, La., and Boston—giving you and your bonding agent additional local underwriting expertise. Further contract office openings are planned for 2017 as we continue to be a consistent bonding source for contractors across the nation.

CAPACITY

ORSC is well positioned to assist middle-market contractors with bond programs based on flexible, common-sense underwriting. We write contract bonds, bid bonds, performance and payment bonds, and maintenance bonds in all 50 states with bonding capacity currently at $50 million. We use common-sense underwriting because each opportunity is unique to us. Your business' strengths are unique to you and deserve the consideration we've been trained to provide. We'll never use a computer-based algorithm to determine your success.

STANDARD BOND PROGRAMS

Need help setting up a standard bond program? Having a standard bond program in place offers contractors a more nimble approach to bidding on projects and turning them into profitable outcomes. We offer a consultative approach that helps contractors understand the bonding process through the eyes of an underwriter. Understanding the bonding process is an essential element of a contractor's growth.

CONTRACT BONDS FOR GROWING CONTRACTORS

We've got a bonding option for smaller, growing contractors. Our FastBond 750 program, based mostly on credit score, not only offers a quick, flexible answer for a smaller bond, but it also opens the door for small contractors wanting to grow.

It has truly been a remarkable year for ORSC. We hope that you are experiencing profitable growth as we are, and we look forward to offering solutions to your bonding needs in the years to come.

COMPANY CONTACT

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COMPANY HIGHLIGHTS

- A.M. Best rating of A
- $50 million contract bonding capacity
- Licensed in all 50 states
- Writing surety bonds since 1923
- Subsidiary of Old Republic International

FastBond 750

FASTBOND 750 HIGHLIGHTS

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

Key FastBond 750 Attributes:

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- Immediate response
- Ideal for accounts with no formal financial presentation
- Subjectivity is flexible
- All construction trades

Hudson Insurance Company

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COMPANY HIGHLIGHTS

- Rated A (Excellent) by A.M. Best, FSC XV
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Preparing for the First Contractor-Surety Meeting

BY JASON DETTBARN

> "Surety underwriters are committed to the success of contractors, and working together will bring profitability to all parties.

Successful contractors spend time and effort establishing their first surety company relationship. Contractors that want faster answers and the benefit of the doubt from their surety in a delicate situation will always welcome face-to-face visits with their professional agent and underwriter.

Even though surety is an insurance product, qualifying for surety credit is more like qualifying for a bank loan than buying insurance. An underwriter is always evaluating the company based on the three Cs of surety:

- **character:** the integrity of the contractor and its employees;
- **capacity:** the contractor's manpower, expertise and experience to perform a project; and
- **capital:** the financial strength of the contractor and its indemnitors.

Underwriters review a contractor's financials to determine financial strength, but the visit from the surety team gives contractors the opportunity to demonstrate their character and capacity. It builds rapport and sets the foundation for a trusted relationship.

To prepare for that first contractor-surety meeting, a firm needs to understand what the underwriter is looking for and be ready to answer questions about the organization's culture, operations and future plans.

Company Organization

Presenting the company's organizational structure, the professional backgrounds of key personnel and clear roles for them within the firm is a great way to start a successful first meeting. Underwriters like to know who handles job estimating and the review process for those estimates. They also like to know who the project managers are and how often they are on the jobsite. Underwriters might ask about adequate staffing for current work on hand and the ability to add people for planned growth. They also will look to see if there is a continuity plan to cover for any loss of key personnel.

Underwriters also will be looking for evidence of a strong culture in which people work well together and leadership is clearly focused on successful performance and profitability. Everything from an organized office and happy employees to showing well-maintained equipment that is not sitting idle can add to a successful presentation.

Company Operations

Many contractors start and fail because the person in charge is a master at his craft but does not demonstrate the same skill when it comes to running the business.

Surety underwriters will not only be looking at financials, but they'll also want to know how much time is spent managing current work verses looking for new work, how new work is acquired and whether the firm's banking relationship is strong. Does the company have an ideal job size and scope, as well as an ideal size of backlog? Does the company bond back its subcontractors and use good prequalifying methods? The answers to these questions paint a clearer picture of the firm's operations and its capacity to handle the work it has while continuing to grow.

Future Plans

Sharing the company's vision for the future with its professional surety team is a great way to take advantage of their expertise. Knowing the firm has a business plan in place helps demonstrate professionalism. Surety underwriters look for growth goals, but will caution a contractor about growing too aggressively or in areas beyond its expertise or familiar geography.

The first meeting is a contractor's best chance at developing a strong surety relationship that can help the company grow profitably. Surety underwriters are committed to the success of contractors, and working together will bring profitability to all parties.

Jason Dettbarn is regional vice president of contract underwriting for Merchants Bonding Company. For more information, email jdettbarn@merchantsbonding.com.

Beyond the Basics: Three Overlooked Bonds to Keep Projects on Task and on Target

BY ANTONIO ALBANESE

Nowadays, much more is required to ensure a complex construction job will not only be completed, but also that all parties will be compensated. In the construction industry, the most commonly known and secured bonds are performance and payment bonds, which are required by owners, also known as the obligees, on public projects and sometimes on private projects to ensure the work will be completed.

> *"Be sure to work with a carrier that has the expertise to provide the right bonds for the company's needs and offers a full range of surety bond solutions.*

The performance bond provided by the surety on behalf of its contractor client, also known as the principal, guarantees that the surety will complete the performance of the contract should the contractor be terminated. The payment bond guarantees payment to subcontractors and suppliers.

What can be easily overlooked are the other bonds that a contractor may need. Some of these bonds are project specific, and some are general use.

Wage and Welfare Bonds

In states where a contractor employs union workers, it may be required to provide a wage and welfare bond to the union to guarantee the payment of wages or fringe benefits. These bonds are financial guarantees, and the surety will underwrite them more cautiously.

Transactional Commercial Surety Bonds

A contractor also should consider transactional commercial surety bonds, such as contractor license bonds, business services bonds and out-of-state contractor tax bonds. Having a strong understanding of the requirements and risks associated with those bonds can help the contractor better interact with its surety and ultimately facilitate the approval of these various bond types.

Subdivision/Completion Bonds

In addition, contractors should consider subdivision or completion bonds. States, cities or towns require these bonds when a project will impact public infrastructure. The bond guarantees the infrastructure will be restored to its original condition. In some instances, such as home subdivisions, the bond guarantees that infrastructure will be built and turned over to the public entity.

Subdivision bonds take many forms and may be called different things, but they basically have the same function: The principal (contractor or developer) is obligated to perform, yet the obligee does not have responsibilities (i.e., payment) because no contract is in place between the two parties. Many risks are associated with these bonds, including duration. These bonds do not expire and are only released when the obligee accepts the work, which can sometimes drag on for years. Another high risk is payment. The obligee does not have a contractual relationship with the contractor, so it can make a claim for unfinished work despite not paying for the work.

When a developer requires a contractor to provide the subdivision/completion bond, there is a contract between both parties wherein the contractor gets paid for doing the work covered by the subdivision/completion bond. The risk here is there could be a contractual dispute between the developer and contractor resulting in stoppage of payments for work. The obligee under the subdivision/completion bond does not care that the contractor is not being paid. He or she can force the contractor to complete the work regardless of payment.

Other subdivision/completion type bonds include: street permit, road opening, and license and permit. A city or town requires these bonds when a contractor is doing work that would impact a road, sidewalk or other public infrastructure. The obligation guarantees that the public infrastructure will be restored to its original condition. These bonds do not expire, so a contractor will have this exposure to the public obligee until the bond is released. Because these bonds are generally smaller in nature, surety companies are fairly quick to approve them.

There are numerous types of bonds to consider depending on the size and scope of a project, and these are just a few that are often overlooked. Be sure to work with a carrier that has the expertise to provide the right bonds for the company's needs and offers a full range of surety bond solutions. In addition, the carrier should have strong financial ratings with a T-listing greater than the largest single bond the company will need. CE

Antonio Albanese is vice president of surety for Nationwide. For more information, email antonio.albanese@nationwide.com.

Surety's Impact on Emerging Trends in Public Construction

BY JAMES BLY

Public-private partnerships (P3s) are gaining momentum throughout the United States as an efficient way to design, build, finance and maintain government construction projects. Under a P3, the government entity generally issues an RFP to engage a concessionaire for the project. The concessionaire then secures funding for the project while holding the right to use the project property for the duration of the construction, operations and maintenance period outlined in the agreement.

The public sector retains ownership and ultimate control of the public asset in a P3. The concessionaire secures funding for the project and enters into agreements with the government agency, which provides availability payments based on construction, operations and maintenance milestones. These payments can be structured to meet the government's budgetary constraints, allowing projects to be delivered in a shorter time frame while government funding is spread over multiple years and operating budgets.

Government funding shortfalls are the most important reason for public and private partners to pursue a P3. Public entities also believe risk transfer is an important part of the P3 model. Some U.S. sureties also are providing pay-on-demand bond forms that read like an irrevocable letter of credit (ILOC) for owners that do not recognize the value of the accelerated adjudication process in the most recent bond forms.

Generally, the private sector assumes the financing, construction and operational risk, while the public sector retains ownership and sets the standards for the construction and use of the asset.

The concessionaire typically engages a design-build contractor to complete the construction phase of the project. The security requirements for the design-build contractor ideally are structured to meet the needs of the concessionaire and its lender, as well as provide protection for subcontractors and suppliers on the P3 projects.


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Performance Bond With Dispute Resolution

Because subcontractors and suppliers are unable to perfect a lien on P3 projects, surety bonds that include a performance bond with an accelerated dispute resolution process or liquidity feature, as well as a payment bond for the protection of the subcontractors and suppliers, remains the security of choice for the benefit of all project participants. If letters of credit are used in lieu of surety bonds for the security of the contractor's performance, the subcontractors and suppliers will have no recourse against the bank that issues the letter of credit, leaving them exposed to the contractor's default risk.

Two of the top three sureties have been leaders in the P3 surety market, developing performance bonds that include an accelerated dispute resolution process that meets the liquidity needs of the concessionaire and its lender, while providing payment bonds that give downstream protection to subcontractors and suppliers.

One surety has developed a hybrid performance bond that includes a pay-on-demand feature for a percentage of the bond penalty with the balance of the bond coming under the accelerated adjudication process. The accelerated adjudication process guarantees a decision to the obligee within a short period of time through the use of alternate dispute resolution processes outlined in the bond form.

Conditional Surety Bonds

Conditional surety bonds used on P3 projects also benefit the design-build contractor. The built-in adjudication process included in the bond form reduces the contractor's exposure to a liquidity crisis. When an ILOC is called, the bank must immediately pay, and the amount paid promptly converts to bank debt. Contractors and their banks are not given an opportunity to dispute the reasons for the default, and the contractor's liquidity is impacted even when the contractor has a legitimate defense to the claim. With a surety bond, the surety must weigh the merits of a surety bond default versus the contractor's defenses.

The surety has to follow legal duties, including timely response to the demand, evaluation of the contractor's defenses to the default and responding in good faith to the claimant. The surety must respond under the terms of a bond for all valid claims, including paying for damages up to the penalty of the bond, financing the defaulted contractor to completion or hiring a replacement contractor.

However, the surety cannot force the contractor to perform if the contractor has valid defenses to the default. The surety claim process has the advantage of preserving the contractor's liquidity throughout the course of a dispute on a bonded contract until the facts are reviewed and a bond coverage determination is reached. With the accelerated dispute resolution features of the surety products now used on P3 projects, all parties will receive the benefit of prompt dispute resolution and payment of valid claims in a timely manner.

Letters of Credit

Sureties also recognize some owners or lenders will simply avoid conditional payment surety bonds at all cost and will demand letters of credit in lieu of bonds. For those instances, a few sureties are looking to provide bank syndication guarantees where the sureties become a participant on bank letters of credit guarantying up to 50 percent of the ILOC in a reinsurance agreement with the bank. To do so, sureties are participating on a quota share basis while sharing in the bank's collateral package, helping contractors expand their ILOC capacity through the use of the surety market.

Sureties also are becoming more sophisticated creditors through intercreditor agreements that clearly define the first and second security positions for the banks and bonding companies, helping the surety expand capacity with these new products.

Given the choice of security requirements, the surety market continues to provide the product with the best combined benefit for contractors and their obligee in today's evolving construction and surety markets.

James Bly is managing director of subcontractor default insurance and surety analytics for Alliant's Construction Services Group. He also sits on the board of the Construction Financial Management Association and serves as its national at-large director. For more information, email james.bly@alliant.com.

SPECIAL SECTION:
CONTRACTORS' GUIDE TO SURETY BONDING

Surety Industry Advocates For Inclusion of Bonds on Federal and State P3s

BY LENORE MAREMA AND LAWRENCE LeCLAIR

As states and the federal government seek funding for needed infrastructure projects and repairs, they are increasingly considering public-private partnerships (P3s). Unlike traditional methods of procurement, under a P3, the public entity signs a contract with a private partner, which in turn chooses and pays the construction contractor. The public entity commits public funds to repay the private partner, plus a profit, over a period of time, ranging from 30 to 99 years.

Even though procurement methods have evolved—including the use of P3s—construction remains a risky business, making the protections that surety bonds provide for taxpayers' investments and the payment guarantees for subcontractors and suppliers just as relevant and important in P3s.

There is no federal P3 law, and the surety industry does not expect to see such legislation any time soon. Rather, states are looking to Congress for funding for their P3 and other infrastructure projects. One way this is being done is through federal infrastructure banks that provide financing, rather than direct funding, for state P3s and other projects. Such banks can make loans and loan guarantees and provide lines of credit for public works project with rates, terms and lengths of time not widely available in the commercial market.

WIFIA Bonding Requirements

Along with several construction industry stakeholders, the surety industry is advocating for bonding requirements in the Water Resources Development Act (WRDA) reauthorization legislation pending in Congress. The WRDA includes a provision known as the Water Infrastructure Financing and Innovation Act (WIFIA) for financing state and local water infrastructure projects. The surety industry is seeking to include a specific provision in WIFIA that would apply bond requirements as a condition of WIFIA financing for a public construction project under a P3 agreement.

There is precedent for what the surety industry seeks in Congress. In the 2008 National Defense Authorization Act for Fiscal Year 2009, now codified at 10 U.S.C. § 2885, Congress mandated surety bonding for military housing privatization projects after construction performed under the 1996 Military Housing Privatization Initiative experienced some significant quality issues, such as unreliable contractors and others that were unwilling to make repairs. This prompted discussions in Congress regarding accountability on military housing privatization projects, including better diligence in vetting project bidders, resulting in bonding requirements.

While WIFIA is in its infancy, it was modeled after the Transportation Infrastructure Finance and Innovation Act (TIFIA) created in 1998. According to the U.S. Department of Federal Transit Administration (*transit.dot.gov/about/news/us-department-transportation-approves-5459-million-loan-advance-public-transit-los*), the TIFIA credit program is designed to fill market gaps and leverage substantial private co-investment by providing supplemental and subordinate capital. Each dollar of federal funds can provide up to $10 in TIFIA credit assistance and support up to

$30 in transportation infrastructure investment.

Up until 2012, TIFIA had $122 million in funding annually. Because of its success, TIFIA's funding was increased under MAP-21 to $750 million for FY2013 and $1 billion in FY2014. The FAST Act in 2015 reduced TIFIA's funding to lesser amounts for the next five years, but still at significantly higher levels than ever before. WIFIA could follow TIFIA's path, and significant federal dollars could be at risk in financing infrastructure.

Managing Public Funds

The development of P3s is the driving force behind this effort. The federal Miller Act and state Little Miller Acts require bonding of public works projects, but traditional procurements have not involved a private partner providing the financing and managing the construction. State P3 laws also vary regarding security requirements. To manage risks properly, construction under a WIFIA-financed P3 ought to be bonded just like any other federal public works project.

Public money pays for the P3 project in the long run, and such public funds are at risk in a P3, just as they would be when using any other method of delivery. Arguably, the risk to the public entity is increased in a P3 because the public entity is responsible to the taxpayers to deliver a public service or facility, but the public entity does not choose or control the construction contractor and could suffer financial losses if the private partner defaults. Surety and construction associations have been educating Congress on the critical need to protect taxpayer dollars used to finance P3 water infrastructure projects.

Many states have considered P3 legislation in the last five years. According to the National Conference of State Legislatures, 33 states have adopted statutory authority for P3s (as of January 2016). The vast majority of states allow P3s only for transportation projects, but more recent legislation broadly applies to transportation, public buildings and facilities.

Most recent enactments of P3 laws also require bonding. Four states joined the P3 ranks in 2016—Kentucky, Louisiana, New Hampshire and Tennessee—and all require bonding of the construction portion of the P3. In the past five years, the District of Columbia, Georgia, Maryland and West Virginia have enacted new P3 laws that require bonding. In that same time period, California, Ohio and North Carolina amended existing P3 laws to require bonding.

Variations in P3 Laws

State legislatures still need to address variations in their P3 laws. Some states may expand their law beyond transportation projects to all vertical construction. Other states may amend the multiple P3 laws enacted over time to make them all consistent. Several of the existing laws are just a general grant of authority to use P3s. It remains to be seen whether state agencies with these barebones laws, which date back a decade or more, will use them to enter into complex P3 agreements with private partners without a further defined law from the current legislature, particularly if public revenues must be committed for a long time into the future.

The surety industry urges that this process also should include bonding requirements. In particular, state P3 laws that allow bonds and other forms of security need to be clarified to state the design and construction portion of the P3 needs to be bonded, rather than all phases of a P3.

P3s still are a relatively new method to deliver a public works project in the United States. States with the most experience with P3s are Florida, Indiana, Pennsylvania, Virginia and Texas. Ideally more states will follow their lead, and those with newly enacted P3 laws will attract investors. If just New York, New Jersey and Connecticut added laws, the U.S. P3 market could expand considerably.

Bonding is sound public policy contained in the federal Miller Act and state Little Miller Acts. These public policies have assured the successful completion of construction projects and protected businesses for decades. Those public policies hold true regardless of which entity is providing the revenue stream for these projects.

Lenore Marema is vice president of government affairs for The Surety & Fidelity Association of America and Lawrence LeClair is director of government relations. For more information, email lmarema@surety.org *or* lleclair@nasbp.org.

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Inside the Mind of a Surety Bond Underwriter

BY SCOTT PAICE

Many children grow up playing with building blocks and Tonka trucks. Some dream of becoming contractors, and a few actually do. Still, hiring young talent is a significant challenge throughout the construction industry. Finding interested candidates for surety bond underwriting is even more challenging. Does anyone grow up thinking they want to be a surety underwriter? What child would even know that this job exists?

Surety underwriters are a rare breed, a somewhat endangered species that is slowly being repopulated as surety and insurance firms rededicate themselves to recruitment and training. And they can be hard to spot. Often, contractors believe their agent or bond producer is their surety underwriter. This is not the case.

The surety underwriter decides whether to accept a risk—not a task to be taken lightly. Contractors know all about taking risks. It is truly amazing how much risk contractors take on a daily basis for a seemingly modest return. Considering all the things that could possibly go wrong in a construction project and the lengthy contracts and specifications involved, it can be downright paralyzing. Likewise, for the surety underwriter—which is, in fact, guaranteeing the contractor's work—a tremendous amount of trust is involved.

No Margin for Error

Surety bond premiums generally run in the 0.5 percent to 3 percent range of the total contract price. Unlike insurance premiums, they are not designed to cover losses and they do not typically fluctuate every year. Surety rates have remained very consistent since the mid-1980s. On average, let's say the blended rate is 1.5 percent, or $15,000, for a $1 million bond. One bad decision resulting in a full penalty bond loss would negate 66 good decisions. In other words, surety bond underwriters often have to be right 98.5 percent of the time just to break even. There is literally no margin for error, and expectations are always high.

Surety underwriters must adhere to company underwriting

guidelines, but they also are charged with growing their book of business, building and maintaining agency relationships, and avoiding losses. It is fairly common in the industry to get annual bonuses based on production and loss results.

According to the Surety & Fidelity Association of America, the surety industry paid out more than $1 billion last year, and the frequency of surety claims is trending up. When a contractor fails, the underwriter feels it as well. Surety underwriting is a high-risk job, and it can be very stressful. In Major League Baseball, Ty Cobb holds the all-time record with a .366 batting average. A surety underwriter batting .985 may not qualify for his or her bonus and may not even keep a job. It is not an industry for the weak and the weary.

While nearly 6,000 insurance companies and more than 650,000 construction firms exist throughout the United States, there are only about 100 surety companies. It is a niche industry, where everybody knows everybody and there is little room to hide.

Brutally Honest Analysis

How can surety underwriters be sure? It is their job to ask a lot of questions and take educated risks. They need to be good listeners and continuous learners. They may need to be brutally honest and confront potential issues or concerns. A good underwriter will not tell you how to run your business. They will explain how the underwriting process works and help you develop your bonding capacity. The more comfortable an underwriter can get with a contractor's financial capabilities and business plan, the more he or she will be willing to stretch on job size and program requests.

A surety underwriter is more of a financial analyst than a construction expert. The job itself is somewhat akin to banking, although the surety company is not usually a secured creditor. Underwriters typically think in terms of numbers and percentages, profit margins and ratios, liquidity and leverage, over/under-billings and over-90-day-old receivables. They need to be able to read contracts and understand the underlying risks in the jobs they are guaranteeing. Underwriters must understand the contractor's financial and job performance history and be able to accurately predict the future. They need to be part psychic and part psychoanalyst.

There is also a human element to underwriting. It is a relationship business that cannot be fully replaced by computer software and automation. Annual account meetings are an important part of the process. It would be a disservice to judge a contractor only by what it looks like on paper. A face-to-face meeting is invaluable for all parties involved.

Underwriters have growth goals, too, as well as pressure from their agents and customers. Sometimes they are the good guy helping a contractor to grow its business with tremendous support; sometimes they are the bad guy delivering the tough decision. One day they are Clark Kent; the next day they are Lex Luthor. More often, they are Hawley Griffin, a.k.a. The Invisible Man. They have to be transparent, but also thick-skinned and able to say no.

Sometimes a contractor may wonder how one of its competitors was able to get a bond. The truth is, not all contractors should qualify. The market is very competitive right now, so it has never been easier to obtain a bond. That doesn't mean these conditions will last.

No Surprises

For contractors working in the public sector, a strong surety relationship is their lifeline and should be viewed with utmost importance. Being ready and willing to answer the underwriter's questions will only help him or her understand the business better and be prepared to provide support when needed. The underwriter's experience and comfort level is invaluable when a contractor goes through the inevitable tough times or has difficulties on a specific job. Nobody likes surprises, especially underwriters. Trends and issues should be addressed early on, and communication is paramount.

Don't be afraid to open up to the surety underwriter. After all, underwriters are just trying to help contractors succeed. And if this business doesn't work out, the underwriter can always fall back on a career in major league baseball, or better yet, with the National Weather Service, where the expectations of being accurate are far less than 98.5 percent. CE

Scott Paice is vice president of surety for FCCI Insurance Group, Sarasota, Fla. For more information, email spaice@fcci-group.com.

How Does Safety Impact Surety Bonding?

BY MIKE CIFONE

While many factors impact surety bonding, some are more obvious than others. Surety companies continually monitor a contractor's financial strength, capacity to execute their projects and the quality of their management team.

A financial snapshot at a particular time may give a good indication of a contractor's current operations, but a surety also will evaluate factors—including a contractor's safety record—that indicate a commitment to long-term success. Prior success is not a guarantee that all future projects will be executed profitably.

A quality contractor will have a realistic long-range plan for where it wants to be in three to five years and how it is going to get there in the current business environment. In addition to a long-range plan, the contractor needs to possess strong leadership to implement the plan. A contractor with exceptional leadership should be able to attract and retain qualified personnel to be successful for the long term.

As a surety monitors what the contractor plans to do and what it actually accomplished, it is important for the surety to look beyond just the current financial results. Favorable results in the short term could be at the expense of developing and achieving long-term profitable growth. A contractor's commitment to training and safety is an indicator of the quality and commitment of the current leadership.

So how does safety impact surety bonding?

The competitive nature of the construction industry—along with hard bids, changing materials prices, labor demands and evolving start/finish dates—leaves little room for error. Any errors in bidding the contract, buying out the contract, and executing the contract can put a strain on short-term profits and expenses related to long-term commitments. The contractor must dedicate resources to training and safety. When managers fail to make a commitment to training and safety, it could have a negative impact on the contractor's ability to obtain surety bonding.

Financial results will be negatively impacted by the increase in insurance costs if a surge in the frequency and severity of worker injuries occurs due to improper safety controls. A contractor's inability to control costs, such as insurance, could make the difference in having the low bid on some projects. The hard-bid nature of most construction projects requires a contractor to control its expenses in order to be the successful low bidder. In addition, more obligees are looking at a contractor's safety record to determine which contractors are "qualified" to bid their work.

> A contractor's inability to control costs, such as insurance, could make the difference in having the low bid on some projects.

Supervision and Commitment

After successfully acquiring the work, a contractor must complete the project with the proper supervision of manpower. Attracting qualified workers is one of the biggest issues facing contractors today. A contractor that does not have a strong commitment to training and safety is less likely to attract and retain the qualified workers necessary to complete the projects on time and within budget. The emphasis on safety starts at the top with management and needs to be a priority for everyone in the company.

Safety incidents or injuries should never be one of the reasons that contractors are unable to finish a project on time. A contractor that cannot obtain substantial completion for a project in accordance with the contract documents could incur additions costs and face delayed start times on other projects.

When safety issues become a factor in a contractor's ability to finish a project, the surety starts to question what other issues might be out there that could have a negative impact on the contractor's ability to complete the project.

If safety and training are not a priority, could there be other areas where management is lax? What about the contractor's ability to maintain equipment, select and supervise qualified subcontractors, and maintain systems to capture and bill costs associated with each project? These are all issues that could be revealed if a contractor does not have a long-term commitment to safety. CE

Mike Cifone is senior vice president of surety underwriting for Hudson Insurance Group, Avon, Conn. For more information, email mcifone@hudsoninsgroup.com.

Surety Bonds, LOCs and Parental Guarantees: What's the Difference?

BY ROBERT MURRAY

A familiar component of the contract procurement process is the provision of performance security that provides assurance to project owners that the contracted work will be completed as agreed. The need for such security is well documented and reflects the complex and risky nature of the construction business.

To address the security need, owners and contractors can be faced with a choice between traditional surety bonds and letters of credit (LOC). Additionally, parental guarantees are often included as a supplement or substitute for the security. These alternatives have unique implications that should be considered by contractors and owners when choosing the best path.

Surety bonds offer contractors significant benefits, such as serving as a separate source of credit, whereas LOCs by nature are part of the bank line of credit for a client. Surety serves as an important resource to help the contractor grow and expand its project base. Because they are underwritten by a surety company, surety bonds are an independent verification of the capability of the contractor. That third-party view is an integral part of a contractor's competitive advantage and helps firms distinguish their project execution capabilities to prospective owners. An LOC is simply a line of credit that does not carry a contractor verification beyond a basic assessment of financial resources.

From a project owner's perspective, surety bonds and LOCs offer different benefits. Surety bonds offer assurance that the contractor is capable of completing the contract on time, within budget and according to specifications. A significant characteristic of surety, often overlooked by owners, is that the burden of construction risk is shifted from the owner to the surety company. By contrast, LOCs simply offer a promise to pay on demand, but do not shift the construction risk and serve to keep that risk at the owner level.

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Outside of North America, LOCs are a common performance security tool used by owners, developers and concessionaires. Typically, the LOC will be issued and used as on-demand project security in private and public construction procurement in Europe, Asia and Latin America. However the size of many projects in the United States and Canada requires a level of protection that LOCs cannot provide.

While project owners and others may think an LOC has an advantage over a surety bond because the instrument is payable on demand, LOC coverage is limited in several ways.

- LOCs typically cover only 10 percent to 15 percent of project costs, while actual costs in the event of default tend to run much higher. This protection is significantly lower than surety payment and performance bonds, which typically cover 100 percent of the value of the project, depending on the scale of the job.
- A contractor default on a large, complicated construction project unleashes an incredibly complex series of events that need to be managed before the project can resume work. If the LOC is called upon, it is usually during a crisis situation where different parties with competing interests are primarily concerned with vying for payment, and not focused on getting the project completed.
- The LOC itself does not help get the project completed, whereas an experienced and knowledgeable surety team has resources to step in to expediently get the job back on track. An owner does not have the level of construction experience, nor does it maintain ongoing relationships throughout a project like a surety partner does.
- LOCs do not contemplate managing claims and liens against a project, as the role of the issuing bank begins and ends with honoring a demand for payment.

U.S. construction is complex due to the size of projects, the challenging work conditions, and the many different subcontractors and types of workers. Experienced surety professionals deeply understand the nuances of the procurement process and project risks, and act as advocates for the contractor and the project overall. A contractor that has a strong relationship with a surety partner benefits from the surety knowing the total project and financial risks the firm is currently facing across its existing project portfolio. This insight helps the contractor determine the level of risk it will need to manage on a project.

Parental guarantees are another misunderstood performance security tool. The use of the general indemnity agreement is widely known and is the cornerstone of the surety relationship in the United States and Canada. However, when indemnitors and corporate parents of indemnitors are located outside of North America, new issues arise and parental guarantees are often used.

A parental guarantee is the indemnity of a corporate parent to reimburse a surety for losses and expenses from a subsidiary of the parent. Issues that arise in parental guarantees include:

- laws and regulations of the country of domicile of the parent;
- the form of the guaranty;
- specific provisions, such as net worth, long-term debt or other special covenants;
- timing, trigger and limits of liability of actual reimbursement; and
- legal requirements on document execution.

Additionally, the use of parental guarantees does not consider the prequalification of the contractor and that contractor's ability to successfully perform. While parental guarantees can supplement the performance security provided by surety bonds, there is no established mechanism to manage a default and successfully complete the project.

The use of parental guarantees as a risk mitigation tool requires an in-depth knowledge of the local regulatory climate and a clear understanding of the expectations of all parties. When applied correctly, parental guarantees can be a valuable tool to manage and mitigate risk and meet stakeholder needs on construction projects in North America. CE

Robert Murray is head of surety for Zurich North America. For more information, email robert.d.murray@zurich.com.

An Overly Soft Credit Environment Can Adversely Affect Small Contractors

BY KEVIN LORENZ

Fast bond products or "quick issue" bonds have sped up the process of obtaining a bond for smaller projects. Quick turnaround and minimal underwriting—sometimes solely based on credit score—allow for speedy answers when time is of the essence. That's the upside.

The downside of this softer credit-based underwriting is that the relationship-building and counseling process can suffer. These quick-turnaround transactions have drastically reduced the information-gathering discovery phases of early agent, contractor and surety relationships, which can have far-reaching effects for a contractor down the road as the company tries to grow.

Suppose someone has $10,000 to invest for retirement. Option one: He simply takes it to the bank and opens up a CD. It's in a safe place, growing a little—job done. Option two: He can talk to a financial advisor and take a little time upfront to share his retirement objectives, whether it's fulfilling a lifelong dream of sailing around the world or investing in savings for family members. Once the individual's end game is apparent, the advisor gains direction on risk tolerance for investing to help reach incremental goals.

The same holds true for contractors with smaller bond needs. Yes, they can obtain a quick credit-based bond for small projects. When it comes to being a small contractor, the product is appropriate for the need, but contractors should beware of the process, or lack thereof. What's often sacrificed here is the sharing of strategy and objectives.

Does the contractor want to contract for smaller projects forever? Does the contractor want to continually pay the higher premium for a quick bond product? Does the contractor want to look only at the short term? Or can the company take a little time upfront with its surety agent, like one would do with a financial advisor? Can the business owner share growth objectives and a little about financial aspirations so there's more strategy to help the firm grow?

Then vs. Now

In the past, a contractor and its surety relationship grew up together, following a discussion about the CPA's capabilities to provide a compilation, or even a review. A discussion with the banker would reveal what it would take to get a bank line of credit and consequential increases to the line. Irregularities with the bookkeeping would have been pointed out and discussed.

A general understanding of the contractor's overall capacity would have evolved, and a comfort level would have been achieved at each stage of the process. The agent and the surety underwriter also would have become comfortable with the character of the business owner and the operations staff, and would understand the succession plans and long-term viability of the business.

These steps still take place to qualify a contractor for a standard surety program, but too often they occur at the last minute instead of as part of a relationship developed over time.

The Trouble With Guaranteed Issue

The surety industry has made the credit-based quick bond process look artificially easy. Contractors are sometimes shocked when they cross an imaginary line and are

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requested to answer even minor underwriting questions. They often find themselves ill-prepared to respond because the communication, counseling and positioning didn't happen during the credit-based process, nor did it continue after approval. In many cases, there is a lack of discussion about the next step. What comes after a fast bond?

Surety underwriters also assume that the agent is aware of the level of surety participation when more information will be needed. Not having an extensive relationship with the customer, a surety agent might be completely unaware that the contractor wants to grow. When a larger bond need does arise, very little is often known about the contractor's banking relationship, the key people in the organization or what its CPA is bringing to the table.

Education Needed From the Start

Where does the industry go from here in order to provide the best service to growing contractors? Contractors should look for a small bond program that has different levels of underwriting. In other words, the contractor should be prepared for more information to be requested as the requests for bonds get larger. Doing a little more work upfront will reduce the anxiety of having to do it all later.

Everyone on the surety team needs to understand the contractor's business plan and the timeline on that plan. It's best for a contractor's surety education to start with the first bond need—regardless of the speed at which it is approved.

Remember, a big contractor was once a small contractor. Be open to the probing questions that will help set the business up for growth. Be open to advice from surety professionals, most of whom have degrees and backgrounds in finance, accounting and risk management. Their advice is almost always free and has helped millions of construction business owners get where they are today. Start learning and sharing from surety agents and underwriters from the very beginning—and get ready to grow.

Kevin Lorenz is bond manager for Old Republic Surety Company. For more information, email kplorenz@orsurety.com.


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