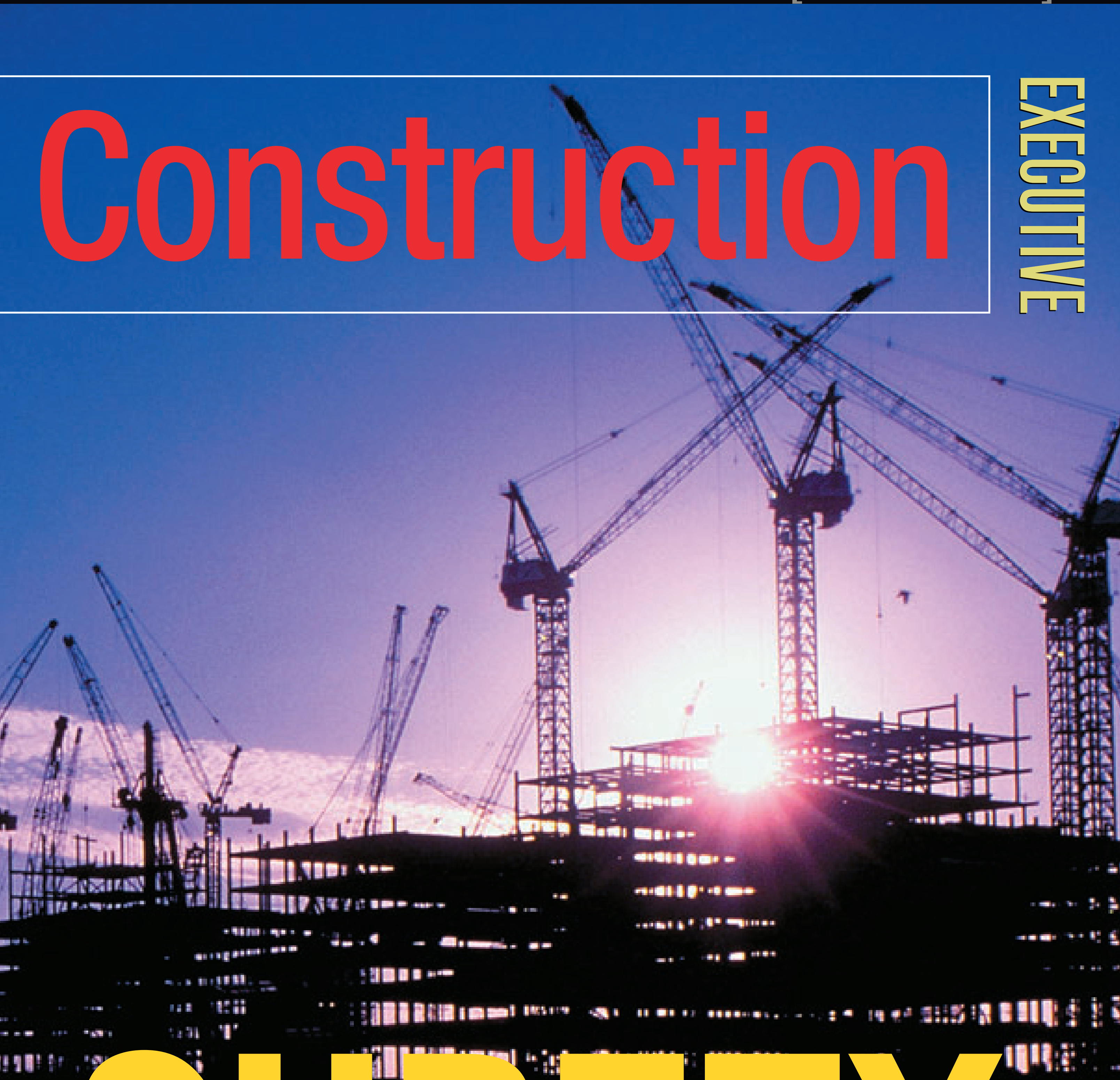
NOVEMBER 2005

Construction EXECUTIVE



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SURETY BONDING

TABLE OF CONTENTS

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Surety Bonding November 2005, a special section of *Construction Executive*, published by Associated Builders and Contractors.

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The National Association of Surety Bond Producers (NASBP) is the international organization of professional surety bond producers and brokers. NASBP represents more than 5,000 personnel who specialize in surety bonding; provide performance and payment bonds for the construction industry; and issue other types of surety bonds, such as license and permit bonds, for guaranteeing performance. NASBP's mission is to strengthen professionalism, expertise and innovation in surety and to advocate its use worldwide. For more information, visit www.nasbp.org.

SURETY BONDING: 2005 MARKET OVERVIEW

Executives Optimistic about Surety, Construction Industries

BY MARC RAMSEY

Today's surety industry may have tightened its belt a notch, but there is still room at the table for many contractors. Surety industry executives, who offer their perspectives on the state of the surety and construction industries, say there will be plenty of bonding availability in the middle market for those who qualify. And while availability may be tighter in the smaller and extremely large markets, sureties can meet the needs of the very best contractors.

SURETY AVAILABILITY

"I believe 2006 and 2007 will be positive years for the surety industry," says Doug Hinkle, chief underwriting officer, CNA Surety. "The effects of more conservative underwriting in the industry over the last couple of years in both contract and commercial surety has led to improving loss trends. In conjunction, we are seeing a much-improved construction market in both the public and private sectors and, of course, the recently signed federal highway bill will lead to greater and more consistent funding for public infrastructure work across the country."

Timothy Mikolajewski, vice president of contract surety, Safeco Surety, also cites the federal highway legislation in predicting a fairly robust construction economy over the next two to three years. "The passage of the federal highway legislation will provide much-needed matching funds to the state DOTs," he says. "Infrastructure project opportunities in general should provide plenty of opportunities and be the catalyst for a strong construction economy."

"Overall," he continues, "I'd say the surety industry is strong and will continue to get stronger over the next few years. Good underwriting discipline combined with appropriate pricing for the risk and a strong construction economy should fuel good results for the industry. These good results will allow the surety industry to provide the capacity to qualified contractors to take advantage of what should be good project opportunities."

However, William Cheatham, president of Zurich North America Surety, expects the economic environment for construction to remain stable rather than improve significantly. "The recent New Orleans catastrophe should remove some of the short-term risks," he says. "However, the construction and surety industries will have to manage labor and material shortages, while experiencing escalating costs."

Casey Warnecke, senior vice president of Marsh Global Surety Practice, also believes results in the industry have stabilized. "As long as the main players manage their business effectively, thereby avoiding catastrophic losses, there is reason to be optimistic for the next two years," he says. "Sureties today are using more sophisticated credit scoring and pricing models and are doing a better job managing their overall portfolios in order to justify the capital that is being extended to them by their company; so this bodes well for the future."

On the other hand, the surety industry can be a catalyst for construction industry success at all levels. "For a surety to add value," Zurich's Cheatham says, "it needs to provide more than simply a piece of paper. Contractors should draw on the experience of a surety for advice. Unfortunately, the large contractors seem to value the surety relationship more than the small- to mid-market contractors. That is especially unfortunate when you recognize those are the most vulnerable contractors."

Terry Lukow, executive vice president of St. Paul Travelers, is cautiously optimistic that the surety industry is in recovery. "I think it's still a very fragile environment," he says. "It is recovering, but we're not there yet."

"I think we're going to see more of the same," he adds. "If you look at the changes in the surety industry in recent years, companies are starting to make decisions based

areas that may take up to seven years. The Veterans Administration, for example, has hundreds of millions of dollars committed to building new hospitals, throughout the United States and Puerto Rico."

Michael J. Cusack, senior vice president, regional surety director and operations board member of Aon Construction Services Group, is more cautious about the construction industry climate. "Given the prevailing climate for increased interest rates and higher energy costs, albeit sound, I believe the fundamentals of this market dictate that construction expenditures will remain static during 2006. I do not envision any significant uptick in the market until the second half of 2007 at the earliest," he says.

Henry W. Nozko, Jr., president of ACSTAR Insurance Company, points out, "The normal expectation is that acquiring and increasing surety credit during 2006 and 2007 most likely will be easier. However, our expectation for 2005 was similar, and that has not really occurred. Therefore, the easing of credit during 2006 and 2007 should probably not be considered a given," he says.

How can a contractor make the most measurable positive impact on available capacity? William A. Marino, chairman and chief executive officer of Allied North America, says, "There are a number of ways a contractor can successfully increase the parameters of the support that it receives from the surety. Levels of worth and working capital can be strengthened through profitable operations or through the infusion of additional equity."

on allocation of capital. 'Are you successful in the surety industry as part of a larger property and casualty company?' The industry has failed to create the kind of economic returns that are demanded of it within the property and casualty industry."

Dennis J. Perler, president of Liberty Mutual Surety, says an improving general economic situation coupled with increasing tax receipts for state and local governments bodes well for construction spending. "When viewing these favorable economic trends, it should be noted that construction is still subject to sector and regional geographic variance," he says.

Terrence Cavanaugh, chief operating officer of Chubb Surety, explains, "The forecast really depends on what part of the country you're in. The state of the industry in Rochester, N.Y., is much different from Raleigh, N.C. But, overall, the numbers will show an increase in construction spending."

CNA Surety's Hinkle adds, "I see the balance of 2005 and 2006 as strong years for construction. Work availability seems to be much improved in most parts of the country."

Karen Barbour, president of The Barbour Group, also expects the economic environment for construction to improve in the coming year. "With Hurricane Katrina, especially, years of rebuilding are in tow," she says. "In D.C. alone, two new stadiums are on the construction slate, spurring redevelopment in surrounding

Two things are certain to have a definite impact on the surety industry, says Edward J. Heine, president of the National Association of Surety Bond Producers, and executive vice president of Payne Financial Group. "Pressure for profitable underwriting results will continue," he says. "Surety company results must reach anticipated returns on invested capital and equity. If they do not, corporate boards may no longer support a surety operation and may exit the business."

And, the underwriting procedures of surety companies will continue to be diligent, he adds. "New underwriting tools, such as credit scoring and comprehensive automation platforms designed to measure account quality, will be implemented by most underwriters. Bond credit will be made available for the strongest risks and will be limited for the specialized and under-capitalized clients," Heine says.

DEMAND FOR SURETY

John Stanchina, senior vice president and division manager of Rutherfoord Companies, sees condominium and multi-family residential construction driving a lot of demand for surety. "This represents a substantial percentage of growth in commercial construction around the country, and virtually all of these projects require surety bonds due to lender and buyer requirements. The question is, 'is this a short-term phenomenon or a long-term trend?' I don't think we know yet," he says.

"Demand for the surety product is again increasing," adds Liberty Mutual's Perler. "As building projects continue to grow in size, more private owners and financing entities recognize that the protections offered by a surety bond are necessary to protecting the significant capital that is invested in bringing a project through to completion. Coupled with a stable economy, expanding population and a deteriorating national infrastructure, both construction spending and the demand for bonds should increase over the next several years. Sufficient surety capacity will continue to be available for qualified, experienced and well-capitalized contractors."

Chubb Surety's Cavanaugh agrees, "We may see more demand for bonds by private owners and lenders as they recognize the benefits of financial protection."

Sureties have paid more than $7 billion in claims on contract bonds since 1992, according to The Surety Association of America (SAA). In 2004 alone, CNA Surety's Hinkle says, "The surety industry paid more than $2 billion in losses. Over time, the surety product has proven that it does provide value to owners, general contractors, subcontractors and suppliers. As the construction industry grows over the next few years, the demand for the surety product will also grow."

MEGA PROJECTS

Co-surety arrangements may arise as surety companies look for ways to spread risk. "Larger projects have larger risks," Chubb's Cavanaugh explains.

Contractors may need to form joint ventures to share the risk. Extremely large projects may need to be broken into smaller contracts, where feasible, in order to attract competition and obtain bonding. This segment of the market may be more prone to premium increases and more conservative underwriting conditions.

"WE MAY SEE MORE DEMAND FOR BONDS BY PRIVATE OWNERS AND LENDERS AS THEY RECOGNIZE THE BENEFITS OF FINANCIAL PROTECTION."

NASBP's Heine explains, "There are fewer players responding to this class of business than there were a decade ago, but those that are do a fine job of servicing their customers. New products are being developed to provide capacity to the largest of jobs. Co-surety arrangements are common and reinsurers are playing in this area selectively. The surety industry understands the need to respond to the demands of this sector and is working hard with those that qualify to respond in a comprehensive way."

Zurich's Cheatham believes adequate capacity exists to manage mega projects.

> "FOR SMALLER CONTRACTORS, UNDERWRITING HAS ALSO STABILIZED, THOUGH FEWER MARKET OPTIONS EXIST AND RATE INCREASES HAVE BEEN MORE AGGRESSIVE."

"The real concern for me," he says, "is expanded capacity and the limitation within the surety industry to bring expertise to this segment. Few surety companies have the real expertise to underwrite mega projects."

Michael Murphy, executive vice president of Bush, Cotton & Scott, a Hub International Co., says underwriting terms and conditions, particularly for contractors in the $10 million to $150 million range, have stabilized. "The middle market is clearly the most competitive and provides the most market options to the contractor."

"For smaller contractors," he adds, "underwriting has also stabilized, though fewer market options exist and rate increases have been more aggressive."

Indeed, contractors working on projects under $5 million may encounter challenges in meeting more meticulous underwriting. Several surety companies have programs for emerging contractors, while other companies specialize in the small contractor market. The U.S. Small Business Administration Surety Bond Guarantee Program also may be an option for those unable to obtain bonds by traditional means.

"Small or emerging contractors may find using escrow, funds control and collateral can be useful tools for obtaining bonding," Michael D. Williams, president of North American Construction Services Inc., says.

Murphy says the biggest challenge for 2006 and 2007 likely will be capacity for larger contractors. "With a limited number of markets with sufficient capacity to play in this arena, and those markets retaining much higher levels of liability and paying significantly higher reinsurance costs on these larger exposures, the result likely will be continued upward pressure on bond rates and requirements for additional levels of capital to support these larger work programs," he says.

INDEMNIFICATION

Liberty Mutual's Perler believes the underwriting trend will be to tighten personal indemnification requirements. "Sureties clearly prefer contractor owner-operators to have some form of 'skin in the game,'" he explains. "After all, the contractor stands to gain the most from his business so it is equally important that he be willing to back his job selection decisions with personal indemnity."

However, Michael Mitchell, CPA, CPCU, vice president surety of the Graham Company, believes corporate and personal indemnification requirements may be less demanding in the next few years. "Financial strength and consistency of profitability are more important factors than size," he advises.

Ultimately, time will tell. Regarding personal indemnity, Marsh's Warnecke says, requirements will be determined by the underwriting discipline of the sureties. "Assuming surety results are favorable, it is likely that there will be the typical loosening of underwriting standards, which the industry has seen throughout its history," he explains. "This is typical of any business relative to supply and demand. If more capital enters the business, or if sureties look for additional premium growth, the natural approach is to offer more attractive terms and conditions than the incumbent surety, thus affecting several different underwriting standards, not just personal indemnity. This is already happening to some extent today."

"With respect to a contractor's size impacting indemnity," he continues, "the stronger the balance sheet and earnings history of a contractor relative to the size of its work program and bond needs, the better the chances that there will be less demand for personal indemnity."

In addition to the strength of a contractor's balance sheet, there are other ways to increase bondability. Industry executives advise contractors to become familiar with common pitfalls, so they know how to avoid—and prevent—failure or default.

Zurich's Cheatham cited the top reasons contractors experience difficulties, such as low profit margins, poor estimating, onerous contract terms and conditions, job scope changes and inability to manage cost recovery from the owner.

"Another reason contractors experience difficulties is when the surety industry is too flexible in allowing contractors to leverage capacity against working capital and tangible net worth," Cheatham adds.

St. Paul Travelers' Lukow advises that contractor difficulties are rarely caused by a single event. "It is usually a series of events, and I am a firm believer that the top reason contractors experience difficulties is management decisions made at the senior level of their organizations," he explains. "If a surety is supporting a contractor's strategic business plan and not just transactions, it is in a much better position to see difficulties before they become a reality."

SURETY RELATIONSHIP

The bottom line is the contractor's relationship with a surety bond producer and underwriter is essential, regardless of the state of the surety and construction industry climates.

"The first thing contractors need to identify is what they expect from their surety broker," offers Marsh's Warnecke. "Are they looking for a transactional surety broker or an issuer of bonds, or are they looking for a business partner that can provide them with ongoing consultative advice, which will provide the surety support they need to meet their current and future business plans and ultimately enable them to increase the equity in their organizations?"

"A PRODUCER WITH A LOT OF ENERGY AND WHEREWITHAL CAN CREATE THE SYNERGY FOR ULTIMATE SUCCESS."

"Most contractors," he continues, "want a surety broker that possesses knowledge of their business, the construction industry and one that has a solid reputation in the surety industry, capable of adding value to their business just like any other trusted business advisor with whom they conduct business."

"A good relationship," explains Philip Tobey, vice president of surety for The Dale Group, "starts with the contractor providing complete submissions and answers to questions that will be asked. Documentation and verification are vital in the underwriting process. Be honest with the producer. Contractors should communicate in terms of what their business plans are, what their current difficulties or issues are, and what they anticipate in the future. Don't hesitate to be open with the producer. The producer can't solve an issue if he doesn't know what is going on."

Aon's Cusack advises contractors to transact a certain volume of business to develop confidence and trust in the surety producer/underwriter relationship. "Work through disagreements—while remaining focused on preserving the relationship—and develop mutually agreed upon strategies to service accounts," he recommends. "Although we are both in the business of writing bonds, we must first develop a sense of confidence and trust in each other whereby the outcome of any individual transaction, meeting or conversation will not undermine the welfare and well being of the overall relationship."

Allied North America's Marino adds, "Balance sheet issues that are identified during underwriting meetings should be addressed promptly and action plans shared with the surety and broker. Your broker's proper communication of even incremental success in the execution of a plan to close an identified gap can have a positive impact on the surety relationship."

Barbour emphasizes that contractors need to know whether their producer has the energy to get the job done. "More often than not, contractors want to make sure that their producer is not going to be passive with their business needs. A producer with a lot of energy and wherewithal can create the synergy for ultimate success. Contractors also must be willing to work with their bonding agent and to take some constructive advice on how to improve the firm's operations," she says. "In return, we get the opportunity to grow with the contractor."

"Contractors need to look for a problem-solver, a strategic planner, not a quick-fix solution," The Dale Group's Tobey suggests. "Identify and address the issues, because if you don't do it today, you will face the same questions later on. Interview a few producers and focus on the ones that are willing to work through the issues, and not just produce the bonds."

Despite some challenges, the surety industry will continue to meet the needs of the nation's construction program. Industry executives are guardedly optimistic about future bond capacity and demand, although the market may remain tight for the very small and jumbo contractors. The very best contractors should have no trouble obtaining bonds, while others may have difficulty.

Contractors may need to tighten operations to make themselves attractive to sureties, but that should result in fewer contractor defaults. While the surety industry has been moving through a period of realignment, contractors and owners alike can rest assured that the industry is poised to support the needs of both groups—just as it has for nearly a century.

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NEW STATE BOND REQUIREMENTS AFFECTING CONTRACTORS

BY LENORE MAREMA

The National Conference of State Legislators (NCSL) reported that 42 states had revenues in excess of predictions, a turnaround from 2002 when 42 states had budget deficits. The NCSL report indicates that states collectively slashed $235 billion in spending since 2001. The cumulative $21.5 billion state budget deficits now have been reduced to approximately $1 billion.

However, state spending on Medicaid, health care and education is still draining state funds, thanks to unfunded federal mandates. Several states hope to restore spending for public construction, although taxpayer groups in other states are trying to institutionalize smaller governments.

A summary of just a few state enactments on contract surety and construction follows.

ARIZONA

HB 2579 applies state bond requirements to the Department of Transportation (DOT) construction manager-at-risk contracts. For job-order contracts, the performance bonds may be a single bond for the full term of the contract, a separate bond for each year of a multi-year contract or a separate bond for each job order.

ARKANSAS

HB 1814 authorizes cities and towns to use reverse Internet auctions for purchasing goods and services.

SB 925 allows alternative procurement procedures for municipal projects in excess of $500,000. Bids must be reviewed by a pre-selection committee that interviews five candidates, who will be evaluated on their experience and record of completing projects on-time and within budget. Payment and performance bonds will be required from the winning bidder.

CALIFORNIA

SB 548 permits the state director of general services to establish a master builders risk insurance program for all state construction projects. The deductible for any contractor is $25,000.

SB 1113 repeals a requirement that contractors, in private construction contracts, provide the owner with a notice that contains a warning about mechanics liens and that advises the owner to require payment and performance bonds on the project. The replacement notice in the new law offers alternate ways to protect against liens, without mentioning surety bonds.

FLORIDA

HB 509 re-enacts the Prompt Pay Act and applies it to state agencies as well as local governmental entities. The bill limits retainage that state and local governments may withhold during construction. The new law also reduces the timeframe in which contractors and subcontractors must issue payments to their subcontractors and suppliers once they have been paid. Regarding claims on payment bonds, the notice of non-payment to a contractor in a public project must specify the portion being claimed for retainage.

GEORGIA

SB 270 requires 100 percent performance and payment bonds on public-private construction projects.

IDAHO

SB 1081 stipulates that if bids for a contract on the state highway system were made through electronic means, then a bid bond in electronic form with valid electronic signatures must accompany the electronic bid documents. This is the only state this year that switched to electronic bidding.

INDIANA

SB 244 enacts a prohibition on directed surety in design-build projects. The new law authorizes design-build projects in the state and specifies that public entities must require the design-builder to furnish payment and performance bonds for a project.

KANSAS

SB 33 regulates private construction projects. Owners must pay contractors within 30 days of an undisputed request for payment and contractors must pay subcontractors within seven days of receiving payment. If the parties are not paid within this timeframe, interest is added daily to the payment, calculated at an 18 percent annual rate, until the amount is paid. Retainage is limited to 10 percent of the contract.

SB 94 increases the time from 10 days to 21 days in which a county road and highway project contract must be signed and the bonds submitted. The new law also permits 95 percent of the contract to be paid before it is fully completed. Previously, the limit was 90 percent.

KENTUCKY

HB 449 provides the following:

Any provision contained in any construction services contract purporting to indemnify or hold harmless a contractor from that contractor's own negligence or from the negligence of his or her agents or employees is void and wholly unenforceable. This section does not apply to construction bonds or affect the validity of insurance contracts.

MARYLAND

HB 674 permits the Maryland Small Business Development Financing Authority to guarantee a surety up to the lesser of 90 percent or $1.35 million of its losses under a bid, payment or performance bond under any contract when the majority of the funding is provided by a local, state or federal governmental entity. The threshold on loan guarantees increased from $500,00 to $1 million.

MINNESOTA

SB 1335 requires design-build contractors and construction managers-at-risk to post performance and payment bonds in order to be qualified. A bid bond of not more than 5 percent could be required from the design-build contractor.

Florida Contractors Beware

The Florida Little Miller Act, Section 255.05, Florida Statutes, requires at subsection (2) that a payment bond claimant not in privity with the prime contractor give an initial notice that it will look to the bond for payment and a final notice that it is unpaid. The initial notice must be furnished not later than 45 days after the first of the labor or material is supplied and the final notice not later than 90 days after the last of the labor or material is supplied.

These notice requirements help the prime contractor protect itself from the double liability that can result if the prime contractor pays its subcontractor but the subcontractor fails to pay a supplier or sub-subcontractor that can then make a claim on the prime contractor's payment bond. With notice, the prime contractor can issue joint checks, require releases or withhold funds to cover its exposure to payment of the subcontractor's debts. Without notice, the prime contractor has no way to know if the subcontractor is paying its obligations.

Another section of the act, Section 255.05(6), Florida Statutes, requires that the bond inform potential claimants of the notice requirements and the one-year suit limitation in 255.05(2). As recently amended, subsection (6) states:

All payment bond forms used by a public owner and all payment bonds executed pursuant to this section by a surety shall make reference to this section by number and shall contain reference to the notice and time limitation provisions in subsection (2).

The importance of complying with subsection (6) is illustrated by the Florida Supreme Court's decision in *American Home Assurance Co. v. Plaza Materials Corp*., which held that the contractor and surety could not assert the notice or limitations defenses under subsection (2) if the bond did not comply with subsection (6) and the claimant could show that it was not already aware of the notice and suit requirements. Thus, if the bond form required by the public owner fails to refer to the notice and suit limitations in subsection (2), the prime contract and its surety can lose the protections afforded by the statute.

In the past, many public entities in Florida routinely used bond forms that did not comply with subsection (6), which is why the legislature amended the subsection to explicitly state that the public owner must use a form that references the notice and limitations provisions of subsection (2). The amendment only took effect on June 14, and bond forms, like other documents, tend to acquire a life of their own.

It is crucial, therefore, for prime contractors, bond producers and sureties on Florida public projects to be alert to the statutory requirements and insist that any payment bond form proposed by a public owner comply with Section 255.05 and contain the references required by subsection 255.05(6).

By Lenore Marema

MISSISSIPPI

HB 1290 clarifies the rights of claimants on performance and payment bonds. If the obligee is the owner, then the suit must be brought within one year of completion or actual use or occupancy, whichever is earlier. If the obligee is not the owner, then a suit must be brought within one year of final payment.

If only a performance bond has been issued, suppliers and laborers can bring suit six months after final completion or actual use or occupancy, whichever is earlier, if the obligee has not brought suit. If only a performance bond is given, then only one action shall be brought for payment and performance claims. If a separate payment bond is given, then only one separate action shall be brought on the bond and intervention shall be allowed in accordance with existing law.

NEVADA

HB 34 raises the maximum amount of money that can be collected from the State Contractor's Board recovery fund from $30,000 to $35,000 for actual damages. Furthermore, the bill raises the maximum amount in claims that could be recovered from the fund against one contractor from $200,000 to $400,000.

NEW HAMPSHIRE

HB 263 allows design-build and construction manager methods of delivery for major capital projects in the state. The bill increases the amount for which transportation projects are eligible for design-build from $1 million to $5 million.

NEW MEXICO

SB 814 requires a subcontractor on a public works project to post a performance and payment bond if the contract is $50,000 or more.

OREGON

HB 2071 requires anyone making a claim against a contractor to deliver a copy to the contractor's surety company.

SB 477 requires a contractor or subcontractor working on a public project to post a $30,000 public works bond in addition to any payment and performance bonds required. The new bond would be used to pay wage claims of workers, including prevailing rate claims. The law provides that if a business enterprise elects not to post the public works bond, it must notify the public agency that awarded the contract. It also provides that a claim for unpaid wages can be made under the payment bond of the contractor.

TEXAS

HB 2039 waives the sovereign immunity of local governmental entities and permits them to be sued for breach of contract.

HB 2659 requires that a claim against a payment or performance bond in connection with a privatized maintenance contract must be filed against the bond in effect on the date that the basis for the claim arose.

UTAH

HB 105 amends the law to add a further exemption for a person who contracts directly with the payment bond principal. Existing law already provides that a party in privity of contract with the bond principal need not give notice of its claim, and contains certain exemptions. It specifically requires any person who furnishes labor, service, equipment or material for which a payment bond claim may be made, to provide preliminary notice to the payment bond principal.

VIRGINIA

HB 2666/SB 1108 requires any private enterprise, pursuant to the Public Private Transportation Act, to provide payment and performance bonds in connection with the development of any qualifying transportation facility under the act. The new law also requires private entities to include "cost and completion guarantees" in their contracts.

WEST VIRGINIA

HB 2592 creates a design-build act to be implemented by a new Design-Build Board. The new law contains requirements for bid, payment and performance bonds and an anti-directed surety provision for design-build projects.

Marema is vice president of government affairs at the Surety Association of America (SAA), Washington, D.C. For more information, call (202) 778-3637 or email lmarema@surety.org.

EXECUTIVE INSIGHTS

Overview of Industry Developments

BY MARC RAMSEY

Terrence Cavanaugh
Chief Operating Officer
Chubb Surety

Surety providers have a better awareness of their financial metrics and the expected return they need to provide to their parent organization. In addition to proper pricing, there will be more focus on efficiency and expense management, recognizing that there needs to be adequate revenue per customer to handle the credit analysis, servicing of accounts and risk assumed by the surety company. The construction industry will need to address these issues in their own operations to assure they make prudent decisions on risk versus reward on a per-project basis. How will they manage material escalation and availability, subcontractor performance, owner and financing pre-qualification in such a way as to build a consistent operational and financial track record? The focus, discipline and sound execution by both contractors and sureties will drive consistent performance, profitability and support for both industries.

William Cheatham
President
Zurich North America Surety

Zurich Surety is committed to expansion, and that requires growing the staff and skill levels. Technology drives efficiencies within Zurich Surety allowing management of expenses and differentiates Zurich Surety over the next five years. Properly utilized credit scoring can enhance the construction industry by identifying risk characteristics at a peer level review more quickly. At the same time, a surety with this capability can use the objective underwriting process through credit scoring to balance the subjective surety/contractor business relationship. What should evolve is a value-added service that strengthens all parties, maximizing capacity for the contractor. Ultimately, the success with a growing customer makes the surety more profitable. So to speak, it is the life cycle.

Doug Hinkle
Chief Underwriting Officer
CNA Surety

The most common method of strengthening a contractor's balance sheet is through the retention of profits. The composition of the assets and the degree of leverage in the capital structure play a key role in determining balance sheet strength. Using your business as a personal bank or converting business resources into non-business related investments generally undermines the trading value of the firm's financial strength. I have noticed an increase in the number of CPA-prepared financial statements that do not include completed job schedules, a reconciliation of earnings from completed work and current work in progress. This is important information to sureties and banks. The CPA financial statement should be viewed by the contractor as an opportunity to explain in detail how the business is operating. The more clear the explanation, the more comfortable the contractor's lending partners will be.

Terry F. Lukow
Executive Vice President
St. Paul Travelers

Contractors and brokers should focus more on a strategic business plan, rather than obtaining individual bonds or transactions. That is a focus the industry is missing in today's environment. This kind of approach to capacity leads to better business relationships—a strategic partnership, where the surety company is really in place to support a business plan and is looking at a construction firm from a holistic view. A strategic business plan is an assessment of the contractor's internal and external capabilities and a view of its marketplace in the near-term and long-term. It encompasses the risk appetite of the contractor and includes, as part of the strategic financial plan, how the contractor is going to manage their business.

Timothy Mikolajewski

Vice President, Contract Surety
Safeco Surety

I'm optimistic about the surety industry over the next two to three years. Solid underwriting fundamentals have been in place now for the last three years. While pricing still has a ways to go to get where it should be, there has been an upward trend over the last three years. This, combined with the fact that the large losses in the industry have stabilized, is indicative of an upward trend in surety companies' operating results. In addition, all signs are pointing to a rather robust construction economy over the next two to three years, which should give contractors plenty of job opportunities. This good construction economy, combined with the results of sound underwriting discipline and surety bond price increases, should give the surety industry reason for optimism.

Michael J. Mitchell, CPA, CPCU

Vice President, Surety
The Graham Company

A strong balance sheet and consistent profitability are the most important criteria for qualifying for surety bonding. Contractors that recruit and retain good people and make money and retain it in the business are more bondworthy. Contractors should find a professional broker who can provide good, sound business advice and who takes a personal interest in their clients.

Dennis J. Perler

President
Liberty Mutual Surety

In both the construction and surety industries, the quality of execution separates the stronger companies from the weaker companies in a changing economic environment. With the surety industry experiencing significant consolidation and lost capacity over the past five years, contractors should recognize that many insurance companies remain committed to surety. The best sureties will invest in the people, technology, claims-handling capabilities and capital necessary to provide responsive and professional surety service. In today's environment, contractors should examine the financial strength, character and capacity of their surety partners just as their sureties underwrite them. By aligning with a responsible underwriting surety, a contractor is better positioned to have stable and consistent surety capacity critical to long-term success.

Edward J. Heine

President
National Association of Surety Bond Producers
Executive Vice President
Payne Financial Group

A contractor's relationship with a professional surety agent/broker and surety underwriter can generate tremendous value. The surety professional has the benefit of working with a broad range of clients in the construction industry, and that knowledge creates perspective and resources that can assist their customers with their business plans. The surety industry loss ratios are improving and the capital base supporting the industry is generating improving rates of return that are necessary to ensure long-term stability. Several factors contributed to the loss activity, including poor accounting/cost controls, onerous contractual and bond language, too-rapid growth and a lack of management continuity. The application of such lessons learned in the management of a surety relationship can be beneficial. Construction firms that work with their surety professionals to assess such areas on a regular basis and measure their results should be positioned for success over the long term.

Michael Murphy

Executive Vice President
Bush, Cotton & Scott,
a Hub International Company

There appears to be more-than-adequate industry capacity and market choice to handle the needs of most small to middle-market sized contractors with work programs up to the $150-million range. While the industry as a whole continues to put heavy emphasis on the retention of profits within the operating entity, more than an adequate number of markets are aggressively pursuing this class of business, providing these contractors with stable and competitive underwriting, indemnity and pricing terms and conditions. However, in the case of subcontractors, the choice of market options remains much more limited. The industry will continue to scrutinize subcontractors' balance sheet components, particularly underbillings and reliance on revolving bank line borrowings, as well as overall leverage and geographic spread.

John Stanchina

Senior Vice President and Division Manager
Rutherfoord Companies

There is so much work in the construction market that the number-one challenge for contractors over the next 24 months will be managing material, labor, shortages and inflation risks. And correspondingly, the number-one challenge for the surety industry will be to make sure that contractors have a handle on this risk and that the surety industry doesn't go back to the late '90s and overextend itself, heading us back into a losing cycle. We see that the surety market has improved significantly, and it appears 2005 will be an excellent year for the surety industry. There is real competition for middle market surety accounts, and this is beginning to put pressure on the underwriting discipline. Capacity issues remain for both jumbo contractors and mega projects. The only caveat is we can ill afford to have any significant surety markets pull out of the industry, similar to what happened earlier this year with several major markets.

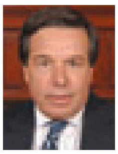
Henry W. Nozko, Jr.

President
ACSTAR Insurance Company

It appears the construction industry will remain strong during the next year, particularly for road construction and for medical and educational facilities. Large projects in excess of $250 million most likely will be bonded by co-surety arrangements, which will probably help stabilize conditions within the industry and result in a better market for principals and obligees. Demand for bonds will continue to rise, particularly in the private sector. Significant losses in recent years were avoided by obligees and absorbed by sureties, which demonstrates the incredible value offered by bonds that continue to be offered at an inexplicable bargain cost.

William A. Marino

Chairman and CEO
Allied North America



Developing a comprehensive financial risk management plan is crucial to the maximization of available surety credit in the current surety marketplace. Owners continue to push additional responsibility and the corresponding financial exposures in the direction of the contractor, and we believe that this trend will only continue to evolve as traditional procurement practices become taxed by the limited available financial resources of both public and private owners. Even though a surety may not be willing to cover some of these exposures under a bonded construction contract, if they believe that these unbonded exposures are not appropriately mitigated, it will have a negative impact on a contractor's surety program. Contractors need to be aware of their limitations and partner with financially strong firms that are capable of providing the necessary expertise when project scope reaches outside of identified core competencies.

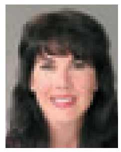
Phil Tobey

Vice President and Director of Surety
The Dale Group

Adequate bonding capacity is based on getting good advice from your agent and CPA and determining what to do with it. I often tell my clients, as well as prospects, I can make all the recommendations and suggestions in the world, but at the end of the day, it's your company. You make the final decision in terms of what to do with that advice. Establishing a reasonable program, acting on good advice, successfully completing jobs and maintaining profitability will eventually lead to additional bonding capacity and hopefully business growth. Being in a tight market where a lot of contractors cannot get bonded, establishing a program, even a modest one, separates a contractor from the rest. It's something to advertise.

Karen Barbour

President
The Barbour Group



Obtaining bonding credit is no different than other investments that provide a return for your risk. A surety company is willing to give you one to 20 times the value of your net worth in order to produce the revenue you need to grow your company. New and emerging contractors should feel confident that for every dollar they retain in the firm, there is a promise of at least 10 more. But unlike other investments, as the owner of the company, you, the contractor, have control over your risk. It is truly up to you to perfect the return.

Casey Warnecke

Senior Vice President
Marsh Global Surety Practice

With the rapidity of change that the surety industry has experienced over the last four-plus years, it is more critical now than ever for a contractor to be working with a professional surety broker that brings value and can facilitate the establishment and maintenance of a strong relationship with a surety. Strategies for contractors' surety relationships today include communicating frequently with the surety in terms of financial and other information, knowing the branch and home office surety underwriters (visit the home office once a year), having a business plan and discussing it with the surety, underwriting the surety and having a backup surety in place.

Michael Cusack

Senior Vice President, Regional Surety Director and Operations Board Member
Aon Construction Services Group

Contractors should routinely review and modify the structure of their company's capitalization. Balance sheets are strengthened by increased retained earnings, but the introduction of other forms of equity and long-term restricted debt can assist firms in qualifying for increased bonding support. Contractors should evaluate if their debt structure is in line with, and supporting, fixed assets. The composition of contractors' capital structure should be appropriate to meet liquidity needs, as well as facilitate growth and increase profitability.

Michael F. Greer

Vice President, Surety
Penn National Insurance Co.

We are very hopeful that the construction industry will remain in a mode of putting profit ahead of revenue. There are selected areas of the country where work is plentiful, but others where contractors are still struggling to find enough volume. Revenue for the sake of revenue leads to losses. More importantly, contractors should not take a blasé attitude about their surety. Long-term relationships do matter when times are tough. A relationship means knowing the people making the decisions and having a dialogue with them. If your surety doesn't want to visit with you every year, then you aren't important to them and you need to find a company that will value you enough to come visit you and ask questions.

Michael D. Williams

President
North American Construction Services Inc.

Many pressures face a small contracting entity today, i.e. the ever-changing costs of materials, employees demanding more benefits (health care, salary) and human resource issues that were not present a decade ago. Couple the ever-growing personal life pressures with competition in the marketplace and no assurance as to where the economy is headed. Stress plays an important factor in the health and success of the organization. Contractors and their owners need to learn to budget their corporate expenses but also their personal expenses so as not to always be leaning on the company as a personal piggy bank. If they can learn to operate lean and live lean, the excess profits can be used to strengthen their position and provide for a rainy day.

Ramsey is the communications manager of the Surety Information Office, Washington, D.C. For more information, call (202) 668-7463 or email sio@sio.org.

OVERCOMING MEGA PROJECT CHALLENGES

BY JAMES ALTMAN

Not many years ago it was highly unusual to see contracts in excess of $100 million. Costs have since escalated. Owners are packaging more into a single contract because they do not have the internal resources to manage multiple projects. The large public/private partnership projects, which usually involve large infrastructure improvements, have become more common. As a result, the industry has seen a greater frequency of projects in this "mega project" range.

Mega projects refer to those contracts with a value between $250 million and $500 million or more. Usually these projects involve joint ventures, require four to five years or longer to complete, and involve substantial risks to contractors and their sureties.

Mega projects present unique challenges to contractors because the analysis and assessment of the risk is more complicated. Therefore, contractors need to consider several aspects of a mega project in order to help ensure successful completion.

By their nature, these projects are big and long-term. They contain high levels of risk, and, as such, a prudent contractor will look to spread that risk through joint ventures or similar structures. When looking at a partner or partners to share the risk, a contractor needs to consider the following issues.

Make sure a potential partner is reliable for the long term. The close partnership lasts for many years, in good times and bad, until the job is completed and accepted. The philosophy, risk appetite and cultures of both partners should be compatible. The financial platforms of the joint ventures should be secure and stable. A partner should bring appropriate technical and other capabilities (i.e. labor, systems, engineering) to the partnership, depending on the needs of the joint venture.

Understanding the owner is important, and the same factors should be at work when choosing an owner. Be comfortable that the owner is a stable, sophisticated and experienced partner in the process and that the owner will be cooperative for many years. Contractors should consider the following:

- Does the owner have a good reputation?
- Is the owner a sophisticated buyer who understands the construction process?
- Are the terms of the contract between the contractor and owner fair and equitable ?
- Are those who act on the owner's behalf—their attorneys, managers and others—reasonable?
- Does the owner have the money needed to complete the project?

A bad owner can have as great an impact on the bottom line as a job that has not been executed well by the contractor. Choosing the right owner is as important as choosing the right job.

Contractors also should evaluate surety capacity. The amount of surety capacity available on a mega project depends on the completion time and size of the project, the size of the contractor's balance sheets in support of the project, the related experiences of the joint venture partners and each partner's surety company. The surety will want to understand how the joint venture addresses the contract risks, the commodity risks, the financing risk and the quality of the joint venture partners.

These specific contract risk exposures are reviewed carefully by the surety and discussed in depth with potential bidders. Normally the surety would like to see acceptable force majeure clauses in which the owner bears the risk of broadly defined force majeure events. The surety usually objects to consequential and actual damages, and damages with no cap. The surety also may want to evaluate financing exposures, unbonded subcontractor risks, long-term warranties or long-term operations contracts and exposure to commodity inflation.

All of these factors influence the approval process by the surety. If the surety brought into the process early enough, it will work collaboratively with the joint venture to resolve contract issues. Once the surety is comfortable with the contract, capabilities and capital available, it will decide to provide capacity to a project.

When a contractor is choosing joint venture partners, it needs to evaluate the joint venture's overall surety capacity. An analysis of the surety capacity can be complicated. The contractor's surety producer and surety should be able to assist early in the process.

All sureties have limits as to how much capacity they can provide on a single project. In some cases this can be as much as $250 million or more per surety per project. Some sureties will not co-surety (which essentially means joint venture) with other surety companies due to credit concerns or internal limitations. Because of reinsurance constraints, some sureties will not write bonds on projects that last

TRADITIONALLY, OWNERS DETERMINE WHAT **LEVELS OF BONDING** ARE REQUIRED ON PROJECTS.

Project	Owner	Contract Price	P&P Bonds
Manhattan Water Tunnel No. 3 New York (Nov. 2004)	New York City Dept. of Environmental Protection	$668,532,680	$668,532,680
US 17/Cooper River Bridge Charleston, S.C. (July 2001)	South Carolina Dept. of Transportation	$531,276,000	$531,276,000
Newtown Creek W.W.T.P. New York (June 2003)	New York City Dept. of Environmental Protection	$493,000,000	$493,000,000

more than four to five years. In the case of mega projects with several joint venture partners and several co-surety relationships, a surety may have exposure on each contractor partner that could exceed its single-job comfort level.

A potential joint venture should be evaluated every time a mega project is under consideration as surety markets may change, appetite for risk may change, and the co-surety relationships and the splits between sureties on individual accounts may change. Again, looking at the surety picture early is important to avoid surprises later.

Traditionally, owners determine what levels of bonding are required on projects. Because the size of projects has grown tremendously, obtaining 100 percent bonds—and the sense of comfort that goes with this—may not be possible. The table lists several recent bonds in the mega-project range.

As these examples demonstrate, in today's market, 100 percent bonding of a job up to the level of $500 million to $600 million is possible. If the contract value exceeds $500 million to $600 million, and the owner wants the security that a higher bond penalty can bring or a 100 percent bond is required by statute, it may be possible to arrange up to $250 million of excess surety over the primary bonds to reach a capacity of $750 million to $850 million. The excess surety product will respond to claims once the primary bond has been exhausted. Excess surety is an option only if the primary bond is $500 million or more and the primary bond is at least 40 percent of the contract amount.

Each mega project is unique and presents issues to the contractor, the owner and the surety that are not common in "normal-sized" contracts. Problems can be overcome by anticipating the issues and dealing with them early. With a good owner, a fair contract and the right joint venture and surety team, mega projects can be profitable and successful for all parties involved.

Altman is a senior vice president, Chubb & Son, and a chief underwriting officer for Chubb Surety, Warren, N.J. For more information, email JAltman@chubb.com.

HOW BOND-WORTHY ARE YOU?

Sureties Look at Variety of Criteria Before Bonding Contractors

Whether your company wants to pursue private or public projects, obtaining surety bonding can be a huge asset, if not a requirement. So how does a contractor go about obtaining a bond?

Sureties consider a number of fundamental factors. One is the contractor's reputation—its relationships with subcontractors, suppliers, lenders and owners. The strength of the contractor's financial statement is another. Is the contractor profitable? Debt, equity, capital, revenue, overhead and indemnity (both personal and corporate) may all be taken into consideration. Does the contractor have an accountant who specializes in construction? Does it have a history of successful projects and a schedule of ongoing and future work? Does the contractor have a comprehensive business plan, forecast or strategy for short- and long-term business? Does it have access to the necessary equipment to do the job? Does it have a risk management plan, and are plans in place in the event of the death or loss of key personnel?

Answering these questions may take time and effort, but they are a vital part of the process of developing key relationships with a surety underwriter and surety bond producer.

Doug Hinkle, chief underwriting officer for CNA Surety Corp., says, "Because surety is a credit business, there will always be a heavy leaning toward the financial resources of a contractor when considering the extension of surety credit. Character and contractor performance—the ability to consistently make money—shape the degree of financial resources required."

Edward Heine, president of the National Association of Surety Bond Producers and executive vice president of Payne Financial Group, adds that a strong, timely and accurate financial statement prepared by a CPA who is familiar with construction accounting says more about a contractor than only its financial strength. "When prepared properly, the statement automatically sends a signal to the underwriter that the surety applicant has developed professional tools to manage his business," he says.

Heine also lists a good credit score, profitability and work-in-process as important. "A surety underwriter assesses trends. How a company has performed over a period of time is a very important indicator," he says. "Underwriters look for consistent operating profitability creating working capital and equity that supports a company's business plan. Work-in-process statements that illustrate good project management through an accurate job-costing system is a focus."

Once the capital structure has been qualified, Heine adds, the business plan of the company is assessed. Personnel and their experience, internal controls, project administration, risk management, references and continuity plans should be explained. Key advisors that specialize in the construction industry, such as bond and insurance agents, CPAs, attorneys and bankers, can provide valuable services to the contractor. "Negotiating a surety program can be a very positive process if the application to the surety company is made by an agent that specializes in the surety product."

Once a contractor has obtained surety bonding, it can begin to improve its bonding capacity. The best way to maximize bond capacity, according to Michael Greer, vice president of surety at Penn National Insurance Co., is by working with an agent who knows the surety business well. Also, the contractor needs to take the lead in forming a relationship with the underwriter.

"Ask what kind of information the company wants or requires, and don't make the surety company wait until five months after your fiscal year-end to provide this," Greer advises. "The couple of dollars you might save with your CPA by avoiding the rush season might cost you multiples of that for your bond capacity."

Greer suggests contractors should worry more about building the net worth of the company, rather than trying to avoid paying taxes. "Many well-intentioned CPAs have hurt a contractor's bond capacity by telling the contractor to do all of these tax strategies that save the contractor money, but hurt their financial condition. Sometimes it comes down to: Do you want bond capacity or do you want to not pay taxes."

Greer recommends having a business plan and reviewing it with the underwriter. "And then stick to it," he says. "Credibility is the biggest factor in bond capacity. Besides losing money, the worst

Opening Markets to Emerging Contractors

By Samuel A. Carradine

In today's surety market, a strong financial statement, an unblemished history and a detailed business plan are vital elements for a contractor's surety capacity. While surety capacity is available for qualified, experienced and well-capitalized contractors, new and emerging contractors may lack the experience and resources necessary to qualify immediately for bonding.

Relationships with a surety underwriter and surety bond producer can provide invaluable resources as the contractor manages the company's growth and development that can help build bonding capacity.

"For most contractors, sufficient bonding capacity is probably the single most important tool to increase revenue because all public work requires bonds and a substantial portion of private work requires bonds," Henry Nozko, Jr., president of ACSTAR Insurance, says.

Edward Heine, president of the National Association of Surety Bond Producers and executive vice president of Payne Financial Group, says while emerging contractors may have experience in a particular field, many have never had experience with bonding, so developing the information that sureties require and designing a financial structure that meets surety requirements can be frustrating.

"Surety bonding is focused on pre-qualification and not everyone in the market can qualify for surety credit," he says. "If one does, the amount of public construction dollars supporting construction activity in a local market is significant and represents an abundance of opportunity."

"A company in a specialty trade that can demonstrate bonding capability may have a more positive profile for general contractors that are seeking higher-quality subcontractors," Heine adds. "In the private sector, it is common for private owners and their lenders to require surety bonding, particularly on larger projects."

Michael Greer, vice president of surety for Penn National Insurance Co., says smart, well-managed contractors use their ability to post a bond as a marketing tool to win jobs.

"The ability to post a surety bond from a credible surety company is a status symbol among contractors," he says. "A surety bond says that a company has undergone a thorough financial and managerial review and that an independent expert is willing to stand behind the company."

So how do new and emerging contractors achieve this status symbol? Many begin by taking advantage of programs that have been developed especially for them to help during this beginning stage.

The Model Contractor Development Program

The Surety Association of America (SAA) and its members are committed to ensuring that bonds are available and accessible to qualified contractors. SAA leads several efforts to increase bonding capacity for minority, women and other emerging contractors. SAA launched the Model Contractor Development Program (MCDP) in 2001 to assist emerging contractors. The program:

- educates small, minority and women contractors about surety bonds and assists them in becoming bondable;
- identifies resources available for obtaining a first bond such as the SBA Bond Guarantee Program and similar state and local programs;
- provides assistance and referrals for obtaining appropriate accounting, project management and financing expertise;
- assists with increasing bond capacity; and
- offers other components such as networking and outreach, and advocacy and policy development.

Technical Assistance to Federal, State and Local Jurisdictions

Many federal, state and local governments have developed or are developing bonding support programs for emerging contractors. SAA members, staff and local surety associations around the country provide technical assistance or guidance with several programs. For example:

- New Jersey Economic Development Authority's Request for Proposals (RFP) engages a bonding consultant to provide surety bonding and working capital loan assistance services for the statewide school construction program;
- The state of Ohio, Department of Development's Bond Guaranty Program for emerging contractors is slated for roll-out later this year.
- The Tennessee Department of Transportation (TDOT) Bond Guarantee Program for Small and Disadvantaged Business Enterprises assists small businesses in obtaining bonds for subcontracts on TDOT construction projects.
- The SAA and the U.S. Department of Transportation (DOT) have a cooperative agreement to rebuild the DOT bond guarantee program in which SAA provides guidance on program operations (underwriting, resource requirements, claims handling and cost). The groups developed an e-commerce methodology for bond execution and processing and assist in providing interns from the SAA/INROADS Internship Program.
- A memorandum of understanding (MOU) between SAA and the Economic Development Corporation of Prince George's County, Md., expands the bonding assistance component of the county's Small Business Initiative (SBI). The SBI provides direct assistance, including bonding assistance, to small and minority-owned businesses with emphasis on the county's multi-billion dollar National Harbor Project.
- The Small Business Administration (SBA) Surety Bond Guarantee program guarantees bid, performance and payment bonds issued by surety companies to small and emerging contractors. This government backing allows sureties to write bonds for contractors that would not otherwise meet minimum underwriting standards.
- The Surety Association of South Texas developed a program for small and minority contractors.

The surety industry's proactive role in the development and implementation of these programs will continue to be an important contributor to their success.

Carradine is director of development and diversity, the Surety Association of America, Washington, D.C. For information on SBA programs, call (202) 205-6540 or visit www.sba.gov/osg/. For more information on bonding assistance for emerging contractors, call (202) 778-3638 or email scarradine@surety.org.

thing a contractor can do is say they are going in one direction and then ask for a bond on something outside of their plan."

As for financial strength, there are some things a contractor can do to improve a weak balance sheet. Henry Nozko, Jr., president of ACSTAR Insurance Company, advises, "Strengthening can usually occur by reducing revenue and overhead, as well as concentrating on collecting receivables and liquidating portions of equipment and inventory."

This takes time, though, according to Heine. "There is no magic wand that allows a construction firm to develop a stronger financial condition overnight."

The retention of after-tax profits in the company is another fundamental requirement. "Generally speaking, surety companies prefer committed capital to support the business, as opposed to the use of debt (from a bank, third party or shareholders). Operating lines of credit that can support cash-flow requirements are important, but surety companies prefer that such debt be short-term in nature," he says.

"Long-term debt created by capital expenditures preserves working capital and is a very useful tool, but the company should not leverage itself to the extent that debt service would impede the company's ability to perform," Heine concludes.

According to Michael Cusack, senior vice president, regional surety director and operations board member at Aon Surety, "In order to develop confidence and trust in the surety producer/underwriter relationship, individuals need to transact a certain volume of business, work through disagreements—while remaining focused on preserving the relationship—and develop mutually agreed upon strategies to service accounts."

The most important characteristics that contractors must demonstrate to qualify for a bonding relationship are experience and profitability, Cusack says.

Nozko agrees experience is important, and asks, "Has the contractor performed similar projects in terms of size and scope of work?"

Ownership stake—in the case of non-public companies—also is important. "The current management needs to have a substantial ownership stake in the company, and the current owner/managers need to have been in place for at least 10 years," Nozko says. During a financial review, Aon concentrates on tangible equity, working capital, the ratio of tangible equity to revenue, the ratio of debt to equity and the ratio of receivables to revenue. For public companies, it considers all of these, plus the length of time the company has been an SEC reporting entity, for which it prefers to see a minimum of 10 years.

The bottom line is the surety company wants the contractor to succeed. The better the surety knows the contractor, the better it can support the contractor. There is not one piece of the puzzle that matters most in the surety relationship.

"Some surety companies just focus on the numbers," Greer says. "At Penn National, we look at the entire picture. We focus on what a company does well and try to strengthen what it doesn't do so well. The key areas are always going to be, does a company understand what kind of jobs it is good at? What are the risk factors in these types of jobs and how does it manage these risks? Can the company make money on its projects, can it manage its overhead and revenue levels and is it willing to leave profits in the business?"

The Surety Information Office, Washington, D.C. is the resource on contract surety bonds. For more information, call (202) 686-7463 or email sio@sio.org.

A Contractor's Scorecard—How Sureties Track Runs, Hits and Errors

By Mike Anderson

Contractors need stable, reliable surety relationships that support their firms' management, business plan and resulting opportunities presented by customers and market segments. If a construction executive can answer these questions affirmatively, he has positioned the firm to have an excellent working relationship with its surety.

- Am I completely familiar with my surety bond producer's surety submission and ongoing work for my company?
- How does the surety analyze my company?
- Have I reviewed my surety's financial analysis? (This is their scorecard for extending credit.)
- Have I communicated what I expect of my surety and do I clearly understand the surety's expectations of my company?
- What are my surety's underwriting results?
- What level of reinsurance support does my surety rely on to service its business?
- Have there been any changes to my surety's single project and aggregate program capacity?
- What are my surety's financial ratings?
- Have there been recent personnel changes within my surety at the local or home office level?
- What is the status of my stand-by surety?
- Do I understand stated vs. "adjusted" working capital/liquidity?
  - Hint: restricted cash, prepaid expenses, accounts receivable greater than 90 days, related party receivables/notes, disputed CEE>B's, inventories, tax refunds and unlisted investments are normally excluded, in whole or in part.
  - Cash value life insurance, retentions, marketable securities and certificates of deposit may be included.
- Do I understand stated vs. "adjusted" equity/net worth?
  - Hint: working capital items, goodwill/intangible assets and asset values above cost are normally excluded, in whole or in part.
  - Subordinated debt may be included.
- Do I know what sureties focus on?
  - original vs. current estimated margins on open jobs;
  - completed projects' margins;
  - underbilled projects;
  - overbillings vs. cash vs. pure job borrow;
  - unearned gross margin and cash flow remaining on open jobs; and
  - projected G&A expense coverage.

Anderson is executive vice president and managing director of surety for Willis, a global insurance broker. For more information, call (610) 254-5634 or email mike.anderson@willis.com.

SURETY INFORMATION OFFICE A VALUABLE RESOURCE FOR CONTRACTORS, SUBCONTRACTORS

One might expect a product that has been around almost 5,000 years to be pretty well known—especially by those who benefit most from it. However, don't be surprised that contract surety bonds—and the benefits they provide—are not a household name.

While the first known record of contract surety bonds appeared in an etched clay tablet from the Mesopotamian region in 2750 BC, it wasn't until the 19th Century that corporate surety bonds came into being. In 1993, the Surety Information Office was established to educate stakeholders in public and private construction about surety bonds. Over the years, SIO has become the primary information source on contract surety bonds.

Supported by the National Association of Surety Bond Producers (NASBP) and the Surety Association of America (SAA), SIO is composed of a small, dedicated staff committed to providing practical information about surety bonds. Here are some frequently asked questions:

Q: What is a contract surety bond?
Contract surety bonds provide financial security and construction assurance on building and construction projects by assuring the project owner (obligee) that the contractor (principal) will perform the work and pay certain subcontractors, laborers and material suppliers.

Three basic types of contract surety bonds exist: the bid bond, the performance bond and the payment bond. The bid bond assures that the bid has been submitted in good faith and that the contractor will enter into the contract at the price bid and provide the required performance and payment bonds. The performance bond protects the owner from financial loss if the contractor fails to perform the contract in accordance with its terms and conditions. The payment bond assures that the contractor will pay specified subcontractors, laborers and material suppliers on the project.

Before issuing a bond, the surety company must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly and performs obligations in a timely manner. To determine whether to bond the contractor, the surety company requires the contractor to undergo a thorough prequalification process, which takes an in-depth look at the contractor's business operations.

Q: How do I get a bond?
Surety bonds are issued through surety bond producers, also known as agents and brokers, who know the surety and construction industries. Surety bond producers usually work in agencies that specialize in surety bonds or in insurance agencies that have a sub-specialty in surety bonds.

The surety bond producer usually maintains a business relationship with several surety companies, which enables the producer to match a contractor with an appropriate surety company. A good surety company and surety bond producer will help a contractor maintain and increase its surety capacity.

Names of producers specializing in surety bonds can be obtained from the NASBP at www.nasbp.org. Click on "Need a Bond." NASBP members adhere to standards that demonstrate professionalism, expertise and innovation in surety bonding.

SIO's "How to Obtain Surety Bonds" brochure and "Surety Bonds: A Guide for Contractors" CD are two additional resources that can be ordered free through the SIO website, www.sio.org.

Q: How do I know I'm dealing with a reputable surety company?
Most large property and casualty insurance companies have surety departments. In addition, for some companies, surety bonds make up all or most of their business. In both cases, in order for a company to write a surety bond in the United States, it must be licensed by the insurance department of one or more states. Although some exceptions exist, generally a surety company must be licensed in the state in which it is doing business or by the state where the obligation guaranteed by the bond is being performed.

For more information on surety companies, SIO's brochure "Surety Companies: What Are They and How to Find Out About Them" is particularly useful and is available free on the SIO website. Another resource is the SAA Bond Authenticity Program - Obligees Guide, found under "About the Industry" on the SAA website, www.surety.org.

Q: How much do surety bonds cost?
Surety bond premiums vary from one surety to another, but can range from one-half of 1 percent to 2 percent of the contract amount, depending on the size, type and duration of the project and the contractor. Typically, there is no direct charge for a bid bond. In many cases, performance bonds incorporate payment bonds.

Q: How does bonding benefit contractors?
In addition to owners, lenders and taxpayers, surety bonds also protect contractors and subcontractors. Bonding demonstrates that a contractor has undergone a rigorous prequalification process and is judged capable of fulfilling the obligations of the contract. Bonding capacity can help a contractor or subcontractor to grow by increasing its opportunities. Furthermore, surety companies can help prevent default by offering technical, financial and management assistance to a contractor. Equally important, a bond requirement ensures that a contractor is competing for the project only against qualified contractors.

SIO explains the surety-contractor relationship in a PowerPoint presentation, "Building Solid Surety Relationships," which is available free on the SIO website.

IN ORDER FOR A COMPANY TO WRITE A SURETY BOND IN THE UNITED STATES, IT MUST BE LICENSED BY THE INSURANCE DEPARTMENT OF ONE OR MORE STATES.

For more information, contact SIO, (202) 686-7463, fax (202) 686-3656 or email sio@sio.org.

CHOOSING THE RIGHT SURETY BOND PRODUCER

A Relationship with a Knowledgeable, Experienced Agent Can Last a Lifetime

A contractor's decision to establish a surety bonding relationship is a wise one. It can lead to more projects and eventually propel the company to the next level of growth. The first step is finding a surety bond producer.

Most surety companies issue surety bonds through a brokerage system, meaning contractors typically obtain a surety bond from a professional surety bond producer rather than directly from a surety company.

The surety bond producer is an integral part of a contractor's external advisory group, which includes attorneys, lenders and auditors. By using specialized knowledge of the construction industry, the bond producer prepares the contractor for the surety company's rigorous prequalification process and helps the contractor establish a business relationship with the surety company.

Finding a surety bond producer is easy. The National Association of Surety Bond Producers (NASBP) represents more than 5,000 surety professionals and producers who meet certain standards of professionalism. To locate a list of NASBP member producers, visit www.nasbp.org and click on "Need a Bond."

Once a contractor has located surety producers in the area, it is important to select the right one. The producer should be knowledgeable of local, regional and national trends and surety markets.

Ed Heine, NASBP president and executive vice president of Payne Financial Group, recommends starting with a surety bond producer who has experience in the surety business and asking key questions, including: Does the producer have a relationship with the key decision makers at the surety company? What do customers say? How has the bond producer helped customers become more successful? Does the producer listen well and respond to service requests quickly?

A good surety bond producer matches the needs and strengths of the contractor to the surety company that will best support the contractor. The producer should offer sound business and technical advice. The producer should analyze the underwriting information and prepare a complete submission to the surety, initially and for ongoing service requests.

The contractor also shares in the responsibility of good communications with the producer. "Include them in your business," Heine asserts. "Don't make the process of getting a surety bond and managing a surety program cumbersome. Find someone who you like, and give them the communication and information that they need to service your company. Such responsiveness is all that it takes."

For more information, contact the Surety Information Office, (202) 686-7463 or email sio@sio.org.

What Does a Good Producer Do?

- facilitates the underwriting process;
- understands the needs of writers and customers to establish relationships that are mutually supportive;
- runs an efficient operation. If customers are small contractors or infrequent users of surety credit, the producer needs to choose the markets and systems that create service efficiency for these clients;
- reviews contract documents to determine if the contractor is taking excessive risk;
- conducts a background investigation of the contractor's past contractual obligations;
- recommends a responsible line of credit consistent with the contractor's capabilities;
- tailors the contractor's submission for the specific needs and requirements of the surety company;
- guides the contractor through a formal presentation. The producer facilitates and maintains close communications between the contractor and surety company with regard to periodic reports on work in progress, financial performance and business plans.

BY MICHAEL STRAHAN

Timely, Accurate Bond Requests

During the past five years, several surety companies have consolidated, downsized or exited the market. As a result, surety resources are thinly spread. Some are short-staffed and are training relatively new underwriters.

In order to return to turn the tide, the surety industry has tightened its underwriting guidelines, and any leniency toward sloppy or inaccurate reporting has evaporated.

Inaccuracies related to bid bond requests or supporting information that underwriters need to approve bonds can be deadly to the approval process. Inaccurate information not only derails an immediate bond request; it also can give the surety a negative perception about the construction business.

Engineers' estimates can be notoriously inaccurate with regard to actual construction costs. Therefore, it is imperative not to rely solely on the engineer's calculation when submitting a bond for approval to the surety. Doing this sets the company up for a last-minute bid escalation, which will require approval.

If the work is within the routine scope of operations, establish the bond amount based on historical data (which is more reliable than an engineer's estimate). Take the time to gather this data to provide the surety with a more realistic figure and decrease the number of last-minute bid escalation approvals. Although bid estimates occasionally increase and additional approvals become necessary, surety problems arise when bid escalations become the norm and not the exception.

In addition, the cost-to-complete or left-to-bill totals also need to be accurate. Most bid bond request forms ask for the current cost-to-complete or left-to-bill figure. Providing a number that is inaccurate is worse than just leaving it blank—failing to change the number is the worst thing a construction company can do.

As part of the underwriting process, surety underwriters keep track of the backlog to make educated guesses on cost-to-complete or left-to-bill amounts. Provide either an accurate figure or nothing at all. Otherwise, underwriters may perceive that the construction company did not take the time necessary to track the work already in-progress, and/or that the project management and estimating departments do not interact. Either situation is a red flag warning to surety companies.

Last-minute bid requests can cause two problems:

- a busy underwriter cannot handle the request in time and the bond is not approved; and/or
- the surety perceives that the construction company doesn't take time to prepare its bids properly and that it does not target its best markets.

Take time to pull together accurate information when submitting bid requests to the surety. Inaccurate information is not acceptable in today's surety environment. Submit requests with adequate lead-time to allow the surety to ask questions or put the requests into its backlog of other work. Although sureties will accommodate last-minute requests from time to time, the surety-contractor relationship will suffer if this becomes the norm.

Strahan is a surety account executive at Cavignac & Associates, a commercial insurance brokerage firm in San Diego. For more information, visit www.cavignac.com.

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