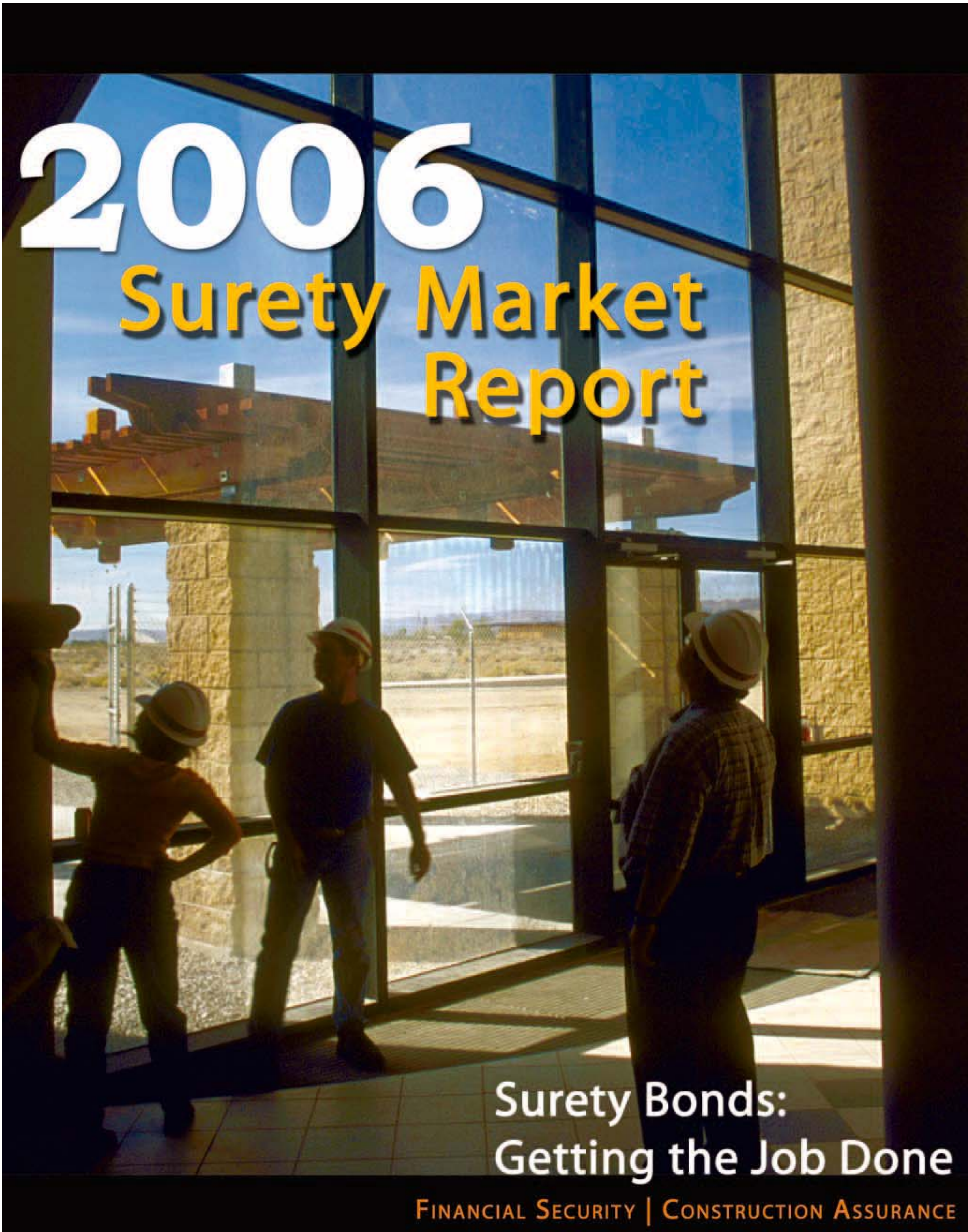

2006
Surety Market Report
Surety Bonds:
Getting the Job Done
FINANCIAL SECURITY | CONSTRUCTION ASSURANCE

LIGHT AT THE END OF THE TUNNEL: SURETY BONDS AVAILABLE FOR QUALIFIED CONTRACTORS

The construction economy is going strong. According to the U.S. Census Bureau, both non-residential private construction and public construction have shown gains for the first quarter of 2006 over the same period last year. And, with the passage of federal highway legislation and some states' renewed focus on long-neglected infrastructure, there appears to be no slowdown in sight. So, will the surety industry be able to meet this demand for surety bonds?

In a word, absolutely!

Most surety executives are optimistic that their industry will be able to meet the construction industry's appetite for contract surety bonds. While opinions vary as to the degree that capacity is available industry-wide, as well as within the small, middle and extremely large, or jumbo, markets, executives say the industry is showing signs that surety bonds are, or will become, more readily available in the near future.

The bigger concern for surety executives is whether contractors are actually qualified for the surety bonds.

SURETY AVAILABILITY

Most surety executives agree that surety bonds are available now for qualified contractors.

"Absolutely, capacity is available," asserted William Cheatham, president, Zurich North America Surety. "But the issue is whether the contractors qualify for it."

Sureties look at a number of factors to determine whether a contractor is qualified for surety bonds. High on this list are the contractor's financial statement and reputation with subcontractors, suppliers, lenders and project owners. Sureties also consider such qualities as a contractor's work history, strategy for future work, risk management or safety program, business succession plan and access to equipment needed for the particular job, among many others.

Steven Swartz, president, South Coast Surety, said, "There are a lot of markets coming in to help the small and emerging contractors, but we are still experiencing a lack of interest to support the larger small contractors and the smaller medium-sized contractors."

Geoffrey Heekin, managing director, Aon Construction Services Group, agreed there is no lack of capacity for small- and middle-market contractors. There may be some challenges, he said, in the jumbo market: "We must figure out a way to bring more capital to this business by rethinking how we assume risk and how we do risk mitigation," he said.

John Welch, president and chief executive officer, CNA Surety, said the surety industry is struggling a bit with capacity for jumbo projects. "We need to find a way to work together to meet the need out there," he said.

On the other hand, Terry Lukow, executive vice president and chief executive officer, St. Paul Travelers Bond, Construction Services, is confident sureties can meet the demand in the jumbo market, even if these $500 million-plus projects challenge capacity and underwriting skills of the industry. "For the right contractor with the right financial structure and management, the right business leadership and the right strategic plan, there is enough capacity and willingness to handle the demand in the jumbo market," he said.

LENDERS AND PRIVATE CONSTRUCTION

Some surety executives are noticing a marked increase in requests for surety bonds by lenders, as more and more require surety bonds as a condition of the loan, especially in the condominium and multifamily housing markets.

"The percentage of private work on which bonds are required varies greatly across the country," said Brian Driscoll, president, The Driscoll Agency. "Even national banks seem to impose different requirements depending on the location of a project. As an example, almost 100% of the private work our customers perform in Florida requires bonds. On the other hand, less than 30% of the private work performed by our clients in New England has bond requirements imposed by owners or lenders."

Lenders are realizing the true value of surety bonds, particularly those who have experienced a contractor default. "I wouldn't be surprised to see more going forward. Suretyship in the private segment is as valuable as in the public sector," Aon's Heekin said. "Surety is an excellent risk mitigation tool for the lender and owner."

"I think owners do see the real value of surety bonds, and that's why there's a strong demand for the product. For decades, the surety bond has lived up to its promise," Timothy Mikolajewski, senior vice president, Safeco Surety, concurs.

While the bonding requirement by lenders is seen as an endorsement of the surety product, some executives warn that surety bonds are not intended to pass financial guarantees of the contractor to the surety. "We're pleased that lending institutions are requiring bonds, but from time to time there's confusion about what the product is designed to do," Zurich's Cheatham advised. "A surety bond guarantees the performance and payment obligations of the contractor building the construction project. It is not designed to guarantee the financing of the project."

Top 10 Writers of Surety Bonds 2005 (Preliminary)*

		Direct Premium Written (millions $)
1.	St. Paul Travelers Group	$885
2.	CNA Insurance Group	$382
3.	Zurich Insurance Group	$368
4.	Safeco Insurance Group	$309.5
5.	Chubb & Son Inc.	$234
6.	Liberty Mutual Insurance Group	$210
7.	Hartford Fire & Casualty Group	$181
8.	Arch Capital Group	$109
9.	HCC Surety Group	$103
10.	International Fidelity Insurance Co.	$86.6
Total All Surety (Top 10)		$2,870
Total All Surety		$4,509

*INCLUDES CONTRACT AND COMMERCIAL SURETY

Source: The Surety Association of America (SAA), "Top 100 Writers of Surety Bonds—United States," 2005 (Preliminary). Detailed statistical reports are available for purchase at www.surety.org. SAA now offers a subscriber service to non-members that includes bi-monthly newsletter; full electronic access to statistical reports and the right to use the reports in presentations; electronic access to the Binder of SAA Standard Fidelity Forms; a copy of the SAA Manual of Rules, Procedures and Classifications for Fidelity, Forgery and Surety Bonds; a web listing; and reduced rates for SAA's Loss Severity Study, other publications and special data requests. For more information, contact Barbara Finnegan Reiff at breiff@surety.org.

CLAIMS PROCESS

That the frequency and severity of claims appear to have lessened is another sign the surety industry climate is improving. Surety executives attribute this improvement to a strong construction economy, credit scoring in the underwriting process and the improved selection process.

"Adherence to this underwriting discipline should continue to help prevent the severity and frequency of losses the industry has experienced in the past five years," said Terrence Cavanaugh, chief operating officer, Chubb & Son Inc.

When claims do occur, a surety has an obligation to the owner and the contractor. "It's imperative that we are responsive to the owners, at the same time being diligent in our investigation on behalf of our clients," Cavanaugh noted.

St. Paul Travelers' Lukow added, "When a contractor says, 'I am in default,' that is the easiest thing for a surety to define. The difficulty is when the contractor says, 'I am not in default,' and we are obligated to do a thorough and unbiased investigation."

The investigation can be complicated. Typically, a default situation involves a contractor and architect who have been working together for two or three years or longer. It is not in the surety's best interest to drag the investigation out. After all, time is money.

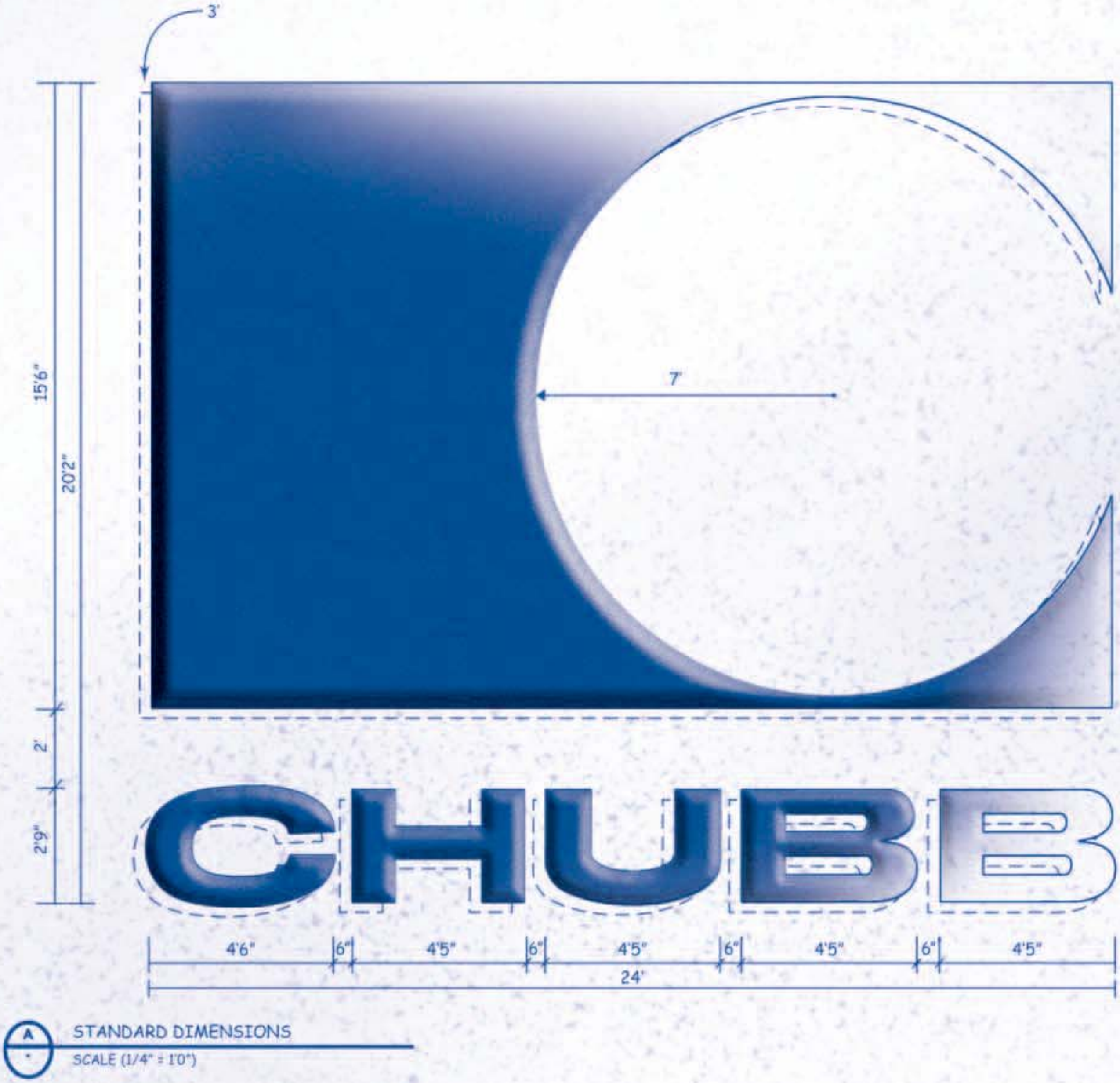
William A. Marino, chairman and chief executive officer, Allied North America, said that determining the problem and magnitude to fix a default takes time: "Figuring out why, when a claim happens, everyone ended up at that point is not feasible overnight." he said

CNA's Welch advised, "Owners have to be prudent to consider the surety companies they're using. It's difficult for them to understand, but they need to find sureties that have adequate claims departments."

Steve Cory, president, National Association of Surety Bond Producers (NASBP), and president, Cory, Tucker & Larrowe Inc., added, "The industry has made great strides in improving the claims process and trying to educate those involved about exactly what it is and why it takes so long. The professional agent has relationships with all of the parties involved and should be kept in the loop because of his or her ability to communicate. A lot of times, because of his or her strong relationships with all of the parties, the agent has a position of trust and can help everybody work together to solve a problem."

"For the right contractor with the right financial structure and management, the right business leadership and the right strategic plan, there is enough capacity and willingness to handle the demand in the jumbo market."

—Terry Lukow, St. Paul Travelers Bond, Construction Services



The Fourth C of Surety.

Sureties examine the Character, Capital and Capacity of *your* business, so why shouldn't you study *theirs*? You'll discover what many top companies already know: one surety stands out — Chubb. One of the *only* major surety providers with an A.M. Best rating of A+ or better for 50+ years, Chubb gets straight A's on those Three C's, plus quite a few other C's as well: Commitment to the surety industry, Counseling expertise, global Coverage, service Consistency, and Continuity of experienced experts who know your business. Why not let Chubb "C" what we can do for you?

For more information, talk to your agent or broker, visit us at www.chubbsurety.com or e-mail us at surety@chubb.com.

BEYOND YOUR EXPECTATIONS

CHUBB

A VIABLE INDUSTRY

The surety industry as a whole—including contract and commercial surety—returned to profitability in 2005, according to The Surety Association of America (SAA). While profitability is a sign that the surety industry is near the end of the record-long hard market, surety executives warn that expanding surety capacity to contractors too soon, too quickly, could extend the period of tough underwriting standards and limited surety availability. It could also mean continued high prices and lack of bidders for construction project owners.

"Surety is a 'cause and effect' industry," noted Dennis Perler, president, Liberty Mutual Surety. "Losses today can be attributed to relaxed underwriting decisions made in prior years. Hindsight shows us that we positioned ourselves for the significant losses that emerged in 2001 and lasted until 2004."

"We have to be careful that we don't walk too close to the edge and slide back into hard times. Certainly, we're on the tail end of the hard market," assured Henry W. Nozko, Jr., president, ACSTAR. "There is no way on earth that this will continue. Once the industry starts to turn and conditions become more favorable, it is almost certain the period of availability will last at least four or five years."

Vincent P. Forte, senior vice president and chief underwriting officer, Surety, American International Group (AIG), agreed, "We can't afford as an industry to fall back into an undisciplined regiment."

MEETING THE NEEDS

Underwriting discipline, adequate pricing and expense control have contributed to the stabilization of the surety industry and a climate of optimism by executives who, for the first time in years of record losses, are seeing light at the end of the tunnel. They are hopeful that sustained profitability across all markets, along with possible new capital entering the market, will lead to surety capacity becoming even more readily available.

Contractors and construction project owners may expect to see continued underwriting discipline, as sureties look to sustain momentum as the industry emerges from the record-long hard market.

Surety industry leaders will be keeping a close eye on several concerns that could affect this progress—including the upcoming hurricane season and potential consolidations within the surety and P&C insurance industries.

Surety executives are noticing encouraging signs that lenders and the private construction sector are recognizing the value and importance of surety bonds, but warn that surety bonds are not designed to guarantee a project's financing. Surety executives also were pleased with improvements made in the claims process in recent years.

Most surety executives were confident the industry would be able and willing to meet the growing demand for surety bonds by the construction industry, even in the small specialty and jumbo markets. ■

EXECUTIVE VIEWPOINTS

TERRENCE CAVANAUGH, CHIEF OPERATING OFFICER, CHUBB SURETY

The metrics that have been brought to the forefront for the industry—underwriting discipline, portfolio management, adequacy of pricing, and expense control—have allowed the industry to return to levels of profitability it has not seen in some time. There still remains a question of whether the proper return on investment is there to attract new capital in a market that has seen capacity diminish in certain sectors.

If underwriting discipline, portfolio management, pricing adequacy and expense control remain a focused measure for the industry, it can secure its stability. The industry swings in cycles, vacillating between fear and hunger: fear of the perils the construction and commercial markets present and hunger for market share as the industry returns to profitability.

Over the past three to four years, underwriting discipline has been the mantra. It is the professional surety producer who has been vital in driving this charge. Those who have provided the value added services to guide their contractors through the tough times have enhanced their relationships and added quality accounts to their portfolio. The transactional, commodity producer has been ineffective and left behind.

WILLIAM CHEATHAM, PRESIDENT ZURICH NORTH AMERICA SURETY

The current state of the surety industry is really driven by three to five markets that participate in the large contractor arena. The rest of the surety companies feed on small to mid-market contractors. You must maintain capacity for large accounts or the product's viability is at risk.

The sizes of projects are extremely large today, which challenge the capacity and underwriting skills of the industry, but there is plenty of capacity for all size contractors. The large market is most at risk, but it is more an issue of the financial capability of the contractors than of availability of capacity. Absolutely, capacity is available, but the issue is whether the contractors qualify for it.

Capacity is king today. Surety companies' capital commitment to the surety product drives availability of capacity. Return on equity (ROE) drives capital commitment of the industry. However, there is insufficient capital coming in to alleviate the pressures

EXECUTIVE VIEWPOINTS *CONT.*

of capacity. There is potential for further shrinkage in capacity, especially in the middle market based on cycles, which means there will be even more constriction of premium writings with fewer companies. Cycles are controlled by surety senior management. There is a tendency to blame reinsurers. The fact is underwriting discipline with adequate ROE controls the surety product destiny.

Credit scoring is a material element in the underwriting process, and the contractor, agents, and brokers should understand that aspect of the business better.

STEVE CORY, PRESIDENT, NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS (NASBP) AND PRESIDENT, CORY, TUCKER & LARROWE INC.

Overall, 2005 was a good year for the surety industry. I think capacity for jumbo projects over $500 million is an issue. Not that it can't be done, but it's something that the owner, contractor and surety need to be out front on and find a workable solution. With a project of that size, everybody needs to step back and find a creative solution that gives everyone the security that they need.

The surety industry has all the makings for another good year. As long as the economy keeps moving along, the construction and surety industries should be in good shape. Everybody needs to keep an eye on inflation. Rising energy cost and price escalations could spell trouble down the line. There is plenty of work, but every contractor that I have spoken to says their No. 1 issue is, "Do we have good quality people to supervise the work and perform the work?" Second is, "Do our subcontractors have the manpower to perform the work?"

Unfortunately, our experience with Katrina is that everybody needs to have a disaster plan in place, both personally and from a business standpoint. Contractors are extremely good at improvising in crisis situations. They're going to respond and take action, and it's important that professional agents, sureties and insurance companies be in a position to respond to the construction industry's response and service their needs.

BRIAN DRISCOLL, PRESIDENT
THE DRISCOLL AGENCY

The large account market probably presents the biggest challenge to construction companies and agents because of the limited number of sureties with the capacity and appetite for this market. The middle market feels to us to be the most competitive segment. In our office, we have more than enough companies who have the balance sheet and underwriting expertise to provide surety credit in the $25 million to $250 million marketplace. Although the small contractor market is usually the first to suffer in a declining construction economy, we don't feel this market segment will be challenged by a poor economy in the near future. We have seen some regional and specialty companies beginning to expand their geographic reach. That competition should be beneficial to smaller and minority-owned contractors.

I think any prediction about the outlook of the surety market in five years is just a guess. We've seen some of the wildest volatility in the history of our industry in the last six or seven years. Right now, the industry appears to be stable from both the reinsurance and primary underwriting perspectives. In the short term, the national construction economy is going to favor well-managed firms. We are seeing a posi-

EXECUTIVE VIEWPOINTS *CONT.*

tive trend of growing margins from our customers. When you combine those results with the underwriting discipline that sureties have implemented in the last five years, the short-term prospects for our industry should be very good. The future success of our business rests in part with our willingness to sustain intelligent and disciplined extensions of surety credit.

VINCENT P. FORTE, SENIOR VICE PRESIDENT AND CHIEF UNDERWRITING OFFICER SURETY AMERICAN INTERNATIONAL GROUP

Industry underwriting standards have improved over the last few years. Today, there is more surety capacity for the small and medium-sized markets. However, with market consolidations and companies exiting from surety, there is not as much capacity for the larger-end contractors as there was a few years ago. AIG Surety is focused on highly capitalized qualified contractors that are in need of surety capacity. Our ability and willingness to bring this additional capacity for the upper tier contractors enables our clients to meet their growing backlog demands. Maintaining underwriting discipline at all times is paramount given the overall capacity, as well as the size and complexity of projects we are looking to bond; we cannot afford to loosen our underwriting standards at any time.

Today, we are seeing more co-surety relationships than in years past. This is due in part to industry consolidations, as well as increased backlog demands as projects continue to increase in size and scope. To meet this demand, sureties may seek out co-surety partners as a means to mitigate exposure to risk on any single account.

Furthermore, joint ventures are becoming more prevalent enabling contractors to spread their risk and take advantage of the expertise that another company might bring to the table, especially on large complex projects.

GEOFFREY HEEKIN, MANAGING DIRECTOR AON CONSTRUCTION SERVICES GROUP

The industry has largely been able to weather some difficult recent events that have certainly resulted in some markets leaving, but those who have remained have had restoration of profitable operations and seem firmly committed to going forward. Some of the economic factors that might have slowed the economy, such as interest rates, did not materialize. Therefore, there has been no slow down in the work available and contractors remained in a healthy state.

The market remains fairly constrained relative to the aggregate amount of markets and amount of risk capital that is available, so that is a little bit of a concern on a going-forward basis. Is there going to be enough risk capital in the surety markets to satisfy the demands of the market place? I'm hopeful, but if there is not some new capital or new entrants into the market in the next two to five years, the demand could exceed supply.

There will be no lack of capacity and appetite for the small and middle markets. I believe they will continue to be well- or overserved to meet their demand. I think there will be even more discipline around the underwriting process for large and jumbo projects, as they bear the most risk relative to scale and scope. If there is any more consolidation with those who serve the jumbo projects and contractors, that could become even more a concern.

THOMAS KUNKEL, PRESIDENT & CEO, ST. PAUL TRAVELERS BOND TERRY LUKOW, EXECUTIVE VICE PRESIDENT & CEO ST. PAUL TRAVELERS BOND, CONSTRUCTION SERVICES

THOMAS KUNKEL

TERRY LUKOW

The surety industry, including contract and commercial surety, did return to profitability in 2005, and I think that is very good for the industry considering how much money was lost in the preceding four years. We're hoping, for the industry's sake, that profitability will be sustained. The industry is in a recovery period. Competition and margins in some parts of the market are under more pressure than others. For the recovery to last, the key is sustaining profitability across the market.

The economic environment appears very good, but a robust economy tends to hide performance problems for a period of time. While we have not had consolidation in 2006, and we had many players leave the market in 2005, we feel there will be further consolidation. The property and casualty industry's future consolidation will have an impact on the surety industry just by its nature.

In the next two to five years, the surety industry outlook has to do with the larger insurance business. In 2005, the effect that the hurricanes and other catastrophes have had on the insurance industry in general also affected commercial reinsurance carriers. If we're looking at a period of increased catastrophic exposure, you have to look at companies more closely to see if the impact on those companies will affect the surety marketplace. As capital becomes more precious, the overall insurance industry could be limited on their choices based on the capital they have available.

JOHN J. LOVETT, PRESIDENT LOVETT SILVERMAN CONSTRUCTION CONSULTANTS

We are a claims consultant for both sureties and contractors. As a result of more stringent underwriting, we have seen a decrease in the claim activity across the nation over the past year. However being in the claims business for close to 30

EXECUTIVE VIEWPOINTS *CONT.*

years, we have seen many such cycles and expect that claim activity will increase due to competition and economic factors. Over the past few years we have seen a large claim increase in the specialty trades, i.e. steel fabrication, erection; roofing; heavy civil and electrical contractors.

I think the more appropriate question is "Why doesn't it take longer?" Our surety clients have always instructed us to provide a thorough yet timely investigation. In fact, many public works bonds require the surety to respond to the claim within a very specific time period, in many cases within several weeks. It's an old saying, but time is money, and in construction, every day, if not hour, counts toward the bottom line for all the parties involved in a bond claim. That being said, there is a lot of ground to cover in that limited period of time.

The surety must ascertain the propriety of the termination, the condition of its principal and the status of the bonded project. Contractors are typically given weeks to prepare a bid for award of a contract, however, the surety is held to a much higher standard to determine the costs of the completion of the project, review all pertinent project records and establish the condition of its principal.

WILLIAM A. MARINO, CHAIRMAN & CEO
ALLIED NORTH AMERICA

The appetite for taking risk on the part of surety companies has remained essentially unchanged when compared to a year ago. The good news is that the industry was profitable in 2005, which is a necessary precursor to the expansion of available capacity from both existing sources and potential new entrants. Generally speaking, surety operations are one of many business units within a larger insurance company. All of these divisions compete for allocations of a finite capital resource. The units with the strongest operating results are the ones that are allocated the capital necessary to expand their books of business. The first step in creating additional capacity is the generation of positive operating results.

Large contractors with multiple sureties may continue to feel the greatest pressure from the current environment of restricted capacity, and there is no sign that this will change in the near future. Regardless of size, if a contractor does not have a track record of strong operating results, a clearly defined business plan and the right professional partners, there is very limited interest.

We see increased interest in the surety product from the private sector. Those with a financial interest in a project, given their role as an owner or lender, are aggressively looking to transfer construction performance exposures. Performance and payment bonds continue to be the preferred means of transferring this risk, but sureties are scrutinizing construction contracts and are not willing to post bonds where established terms are not equitable.

TIMOTHY MIKOLAJEWSKI, SENIOR VICE PRESIDENT
SAFECO SURETY

The insurance industry is in reasonably good shape. There is no question concerns exist regarding the impact of another severe hurricane season. The impact of significant catastrophic losses would have a major negative impact on the industry, particularly in the reinsurance market.

The outlook for the surety industry over the next two to three years is very good. There is a reasonable amount of capacity in the industry and the overall industry results in 2005 appear to be good. The industry should see that positive trend continue in 2006 and 2007. The two factors driving that outlook are a good economy and surety market conditions that favor disciplined underwriting and pricing. Projections beyond three years are difficult, since so many factors could change the outlook.

Consolidation in the insurance industry could be a factor over the next two to three years. That would likely have a negative impact on product availability in the property and casualty market and capacity in the surety market.

HENRY W. NOZKO, JR., PRESIDENT
ACSTAR INSURANCE CO.

Last year we thought credit would become more available to contractors. Here we are a year later and that hasn't happened. While it probably won't be as easy as in the '90s, there will come a time when a bond will be easier to obtain. The anticipation is that now that the industry is looking profitable, credit may become more available. This will probably happen around 2007.

Lenders requiring bonds is one of the single largest drivers—outside of the federal government mandate. We're seeing a new wave of bonds being used on a regular basis for residential condominiums.

It's sort of a broad paintbrush that the surety industry doesn't pay claims. If you take the amount of claims paid by the industry, $6 billion in the last five years, the product works, and it works incredibly well! The claims process is very complicated, and for a surety to come into a situation to resolve, it takes time. It doesn't happen overnight. The surety has an obligation to investigate. It's unrealistic to think a surety can take on a $25-million construction default in a week when the owner and the contractor and the architect have probably been working together for three years. The important thing for owners to know is the surety does eventually unwind the details and the owners didn't pay a penny of the $6 billion.

EXECUTIVE VIEWPOINTS *CONT.*

LORNA PARSON, MANAGING DIRECTOR AND CONSTRUCTION INDUSTRY PROGRAM MANAGER VICTOR O. SCHINNERER & CO. INC.

We have noticed a significant percentage of our largest claims against design professionals come out of delays and extras issued by contractors. From our perspective, we emphasize that design professionals engage in several practices to increase the likelihood that the project will come in on time and budget:

- Create a payment schedule and consistently follow up on it;
- Have constructibility reviews with the owner and contractors; and
- Get a submittal schedule from the contractor and keep a submittal log that documents the dates that items were received and returned.

DENNIS J. PERLER, PRESIDENT LIBERTY MUTUAL SURETY

Most sureties are refocusing on responsible underwriting, proper exposure management and providing real value-added service to customers, obligees and producers. The industry is in the middle of a paradigm shift. As the entire insurance industry has faced downgrades and scrutiny from the credit rating agencies such as S&P and AM Best, pressure has grown on all companies to demonstrate consistent returns on capital. Some astute companies now use tools such as Enterprise Risk Management (ERM) and Credit Scoring Models. ERM is used to calculate, evaluate and monitor aggregations of individual account risks across surety, investments and other insurance lines. Credit scoring models are used to manage portfolios, not to make individual underwriting decisions.

At the customer level, however, it is the underwriter's judgment and relationship with the surety agent and contractor that determines the extension of surety credit. These tools complement a disciplined underwriting process and better position sureties to support their parent's quest for higher credit ratings; compete for internal capital; justify reduced reinsurance costs; and drive consistent business behavior over time. I predict that every surety will inevitably employ these tools.

Our future lies in our people and in the professionalism by which we conduct our business. Service to producers and customers remains the foundation of this business, and I believe sureties will be successful in combining the realities of the new business paradigm with responsive and open relationships.

STEVEN SWARTZ, PRESIDENT, SOUTH COAST SURETY

We seem to be starting to break out of a significantly tight market, and we're starting to see more activity. Some markets have

been making a decided effort to support the larger end of the industry, providing aggressive support and lower rates. A number of markets have come out with easy qualifying programs for the smaller contractor. These programs support single jobs sizes of $200,000 to $300,000 with aggregate programs to $500,000.

Large contractors will have a continuing challenge as far as capacity goes. Bonding may remain a challenge for those established contractors that are not yet generating reviewed statements with revenues of $750,000 to under $2 million that do jobs up to $500,000 to $1 million. In the past, a number of surety markets had reached out to this arena. Unfortunately, some significant losses occurred. However, understanding that this level of surety support is an interim solution with tighter controls and added requirements to upgrade reporting standards, this sector could be profitable for the surety industry to support.

In California, we will see a lot of public works projects because of needed growth in our infrastructure, as well as addressing some long-term neglect. Having the public sector adopt a uniform contract bond form that the surety markets can agree with would be a great accomplishment.

JOHN WELCH, PRESIDENT & CEO CNA SURETY

The state of the surety industry is improving. There was some level of profitability in 2005, and most people are optimistic that 2006 will be very profitable. Our challenges revolve around improving our claim handling processes, which in turn will help us promote our product as the most effective protection against contractor default. Solid underwriting will also aid the process as fewer defaults allows for better use of our claim resources.

A few profitable years should lead to more competition and better conditions such as expanded capacity to areas that are currently underserved. At present, the surety industry has not really loosened. Underwriting is not much different than a year ago. There are still capacity issues for the jumbo risks and the small contractor.

Professional claims organizations make every attempt to resolve a claim situation in an expeditious manner. In most cases, there is no benefit to letting claims situations drag on into litigation as costs normally just escalate. The surety's primary intention is to resolve the issue at hand.

Owners and contractors who obtain bonds need to start with a good, knowledgeable bond agent who will service the contractor and respond to owners if and when there is a problem. That's pretty critical to the process.

WHY BAD THINGS HAPPEN TO GOOD CONSTRUCTION PROJECTS

SURETY CLAIMS POINT TO CAUSES OF PROJECT FAILURE, KEY STEPS FOR KEEPING THEM ON TRACK

Each year thousands of construction projects fail, costing owners, contractors and surety providers time and money. In fact, surety companies paid more than $6 billion on troubled projects between 2001 and 2005.

So why do these projects develop problems and what can be done to keep them on track? The answers largely depend on who you're asking, given the different roles of owner, contractor and surety provider.

A quick survey of recent surety claims shows each group's perspective of the top reasons projects fail:

OWNERS

- Incompetent project manager and/or jobsite supervisory personnel
- Failure to read, understand or interpret contract documents
- Inability to adhere to the project schedule
  - Poor coordination of subcontractors
  - Failure in timely ordering of material, especially long lead time items; and
  - lack of skilled personnel and or insufficient labor
- Disagreements on original scope vs. change order work
- Quality Control problems
- Mechanic's liens, whether filed by the contractor, subcontractors and/or vendors
- OSHA and related safety problems


When it comes to surety, having the right partner is critical.
www.cnasurety.com

"Knowing the things that get in the way and what can be done to get back on track will help everyone succeed."

—Roland Richter, Liberty Mutual Surety

CONTRACTORS

- Failure of owner to pay timely or not at all
- Project is bid and/or started with incomplete and/or flawed project designs and specifications (leads to numerous disputes affecting job progress, payments, extra costs, etc.)
- Contractor has not properly estimated and/or accounted for actual jobs costs
- Failure of owner or representative to respond timely to Requests for Information (RFI), submittals and like documentation
- Refusal of owner to grant time extensions or address force majeure situations
- Failure of the owner to negotiate change orders in good faith
- Over inspection of project by owner representatives
- Failure of construction manager to coordinate co-primes
- Inexperienced/incompetent job site representative
- Absentee and/or uninvolved architect/engineer
- Owner outsourced day-to-day project management to third party construction manager or attorney
- Contract reflects unrealistic terms and conditions

SURETIES

- Contractor lacks financial resources to cash flow backlog
- Contractor estimating and costing systems are inadequate or poorly utilized
- Contractor overextends by taking largest job relative to prior work
- Contractor diversifies into new types of construction without necessary experienced staff or resources to perform new type of work
- Contractor pursues work out of state or in new areas where it lacks experience with local labor issues, regulatory oversight and supply resources
- Contractor takes work with difficult owner and/or general contractor
- Misalignment between contract and bond forms
- Contract reflects unrealistic terms and conditions

At the start of every project, owners, contractors and surety providers all share the same goal: finishing the project on time and budget. An owner needs the project completed correctly, on time, within budget and without liens. The contractor is looking to complete the work on schedule, without defect and to be paid for its work. The surety needs the contractor to execute the contract on time, without defect and to pay all labor, subcontractor and supplier expenses. The goal of all parties should be the successful completion of the project.

So what can everyone do to reach this shared goal?

OWNER

- Ensure that project designs, architectural drawings and specifications are detailed and complete.
- Use reasonable contract language in the contract; do not incorporate covenants and language in the contract that would be clearly objectionable if placed in the bond.
- Use a reasonable bond form.
- Give prompt notice to the surety when material issues arise during the construction process.
- Be reasonable in expectations as to how quickly the surety can respond.
- Expect the surety to limit performance to that which was originally contemplated by the contract; a default is not an opportunity to obtain an upgrade at the surety's expense.
- Provide information and documentation and access to owner personnel to assist the surety in its investigation.
- Pay in accordance with the contract.

- Use attorneys that understand and are familiar with construction and how bonds work.
- Communicate consistently and responsibly with both the contractor and surety.

CONTRACTOR

- Don't bid a project with incomplete design documentation and specifications.
- Bid project work in sectors and geographic territories where the construction company is experienced and has adequate staff, equipment and financial capacity.
- Apply rigorous project costing controls in both the bidding process and the actual prosecution of the project work.
- Understand the labor market in the territory where the work is to be performed—know when to use union labor or not.
- Communicate directly and regularly with the owner, the architect and any other project parties.
- Ensure there is adequate financing for the project.
- Understand the contractual terms and deliverables; make sure the contract has

allowances for force majeure conditions.
- Recognize problems early and formulate action plans to resolve them.
- Respond promptly to owners concerns in a timely and substantive manner.
- When problems arise, seek counsel from consultants or other professionals that are experts in the problem areas; involve the surety early with clear, consistent communication.
- Understand the terms and obligations of the bond and the contract it guarantees.
- Know your surety underwriter and be familiar with the terms of the indemnity agreement.
- Respond promptly to surety requests by providing relevant information and documentation and by providing access to the personnel that are most familiar with the issues.
- Communicate consistently and respon-

sibly with both owner and surety.

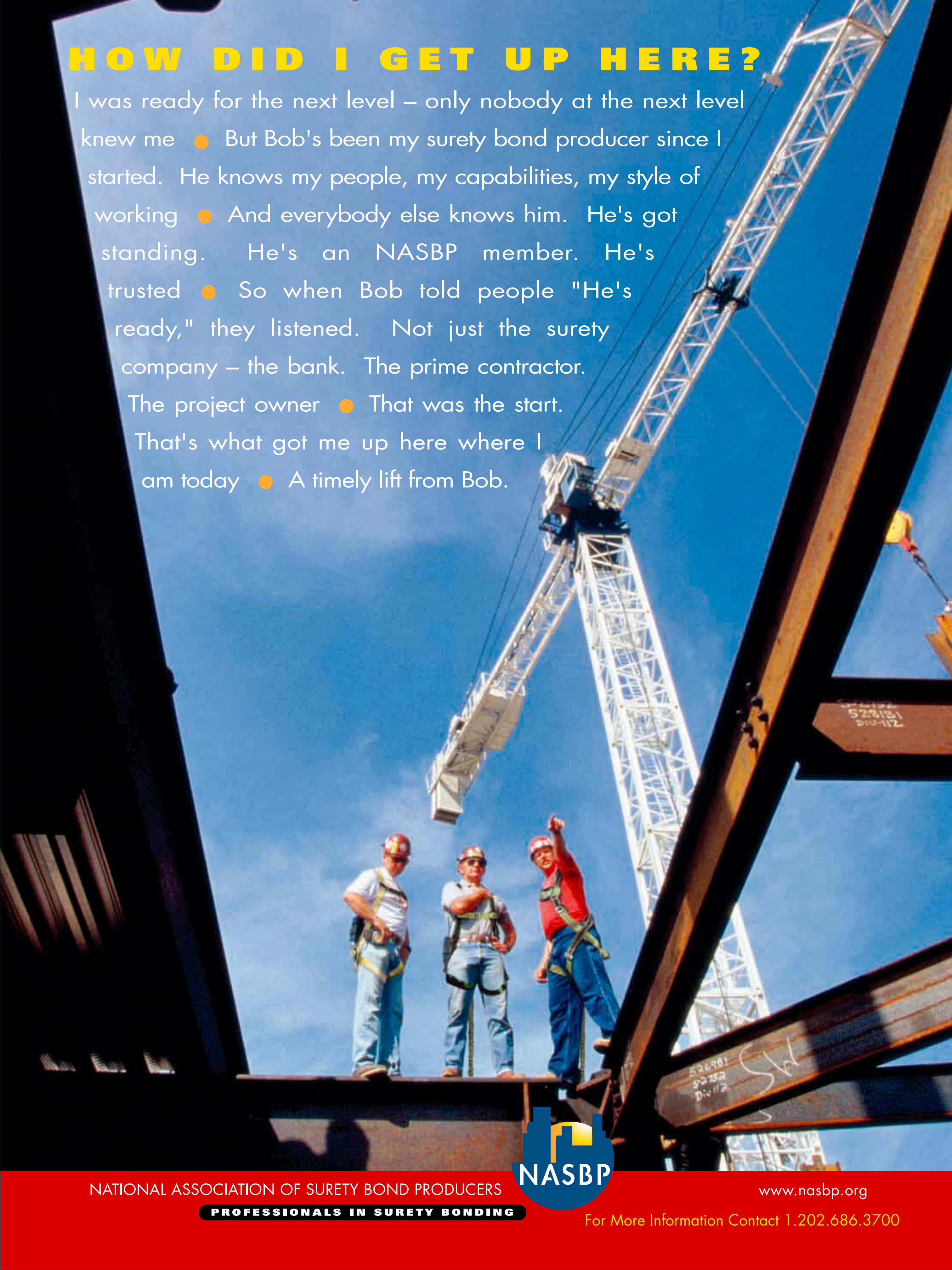
SURETY

- Maintain open and honest dialogue with contractor.
- Supplement underwriters with necessary legal, engineering and accounting staff expertise to assist the contractor if needed.
- Understand the contract obligation that is being bonded.
- Be consistent, responsive and professional in all interactions with owners and contractors.
- Recognize that a contractor knows its capabilities best and maintain a relationship that allows both surety and contractor to discuss higher risk projects in a constructive manner.
- Bid project work in sectors and geographic territories where the construction company is experienced and has adequate staff, equipment and financial capacity.

Through partnering and good communication, both owners and contractors can work together to develop achievable contract terms and schedules, quickly identify and address emerging problems and collaboratively establish solutions to unanticipated challenges in project scope and design. Owners, contractors and sureties mutually benefit from having a process where project managers in real time promptly understand where emerging problems can arise, can communicate the issues to owners and construction management to jointly develop smart, workable solutions and, if needed, engage the broader resources of the surety to prevent further escalation of the problem.

Knowing the things that get in the way and what can be done to get back on track will help everyone succeed. Good communication is important. Both owners and contractors should identify potential issues and problems early and work to find mutually acceptable solutions. Ultimately, project defaults do occur, but interested partners that work together can better achieve a successful outcome. Sureties are an important part of the process resolving problems and stand prepared to help owners and contractors mediate disputes and, if necessary, extend resources to complete the project. ■

By Roland Richter, vice president, Liberty Mutual Surety, (610) 832-8235, roland.richter@libertymutual.com. Dennis Pisarcik, senior surety claims counsel; Kim McNaughton, vice president claims; and Francis McGrath, vice president, Professional Advisory Services, also contributed to this article.


HOW DID I GET UP HERE?
I was ready for the next level – only nobody at the next level knew me ● But Bob's been my surety bond producer since I started. He knows my people, my capabilities, my style of working ● And everybody else knows him. He's got standing. He's an NASBP member. He's trusted ● So when Bob told people "He's ready," they listened. Not just the surety company – the bank. The prime contractor. The project owner ● That was the start. That's what got me up here where I am today ● A timely lift from Bob.
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WHY CONTRACTORS FAIL?

Construction is a risky business. Often that risk rears its ugly head and causes life-threatening losses for construction firms. The ultimate reason that contractors go broke is that they run out of money to meet payroll and pay bills. But, what events lead up to that point? What are the underlying causes of contractor failure?

In conjunction with the Construction Industry Round Table (CIRT), FMI is currently researching the causes of contractor failure. The research includes a study of the literature to determine what is known about business failure. Initial research confirms that the failure rate for construction is higher than most other industries. FMI's "Top Ten Reasons for Contractor Failure," is summarized as follows:

STRATEGIC ISSUES

1. OVEREXPANSION/FLAWED STRATEGY Growing too fast and beyond the financial and human resources of the firm is a classic reason for contractor failure. Eternal optimism is part of the contractor mentality and frequently leads to overcommitting the firm. Having a rational, sustainable business strategy is key to survival and success.

2. VOLUME OBSESSION Contractors define their success by their ENR ranking in terms of revenue or sales. Unfortunately, size and profitability are not necessarily related. Focusing on volume instead of profits causes over-leverage and a lack of a financial cushion when inevitable problem arises. Perhaps ENR should publish a Top 400 list of the most profitable contractors!

3. POOR PROJECT SELECTION Onerous contracts, unrealistic commitments, risk concentration—sometimes a contractor's "best" job is the one they did not get. Very often one bad project can put a contractor out of business. Doing the wrong job, for the wrong owner, under the wrong contract terms can be terminal. Spreading risk through diversification can avoid catastrophic failure.

ORGANIZATIONAL ISSUES

4. INSUFFICIENT "REAL" CAPITAL OR PROFITS Construction company financial statements are notoriously suspect because of the large amount of estimates used to prepare them. Not infrequently, a substantial portion of the equity of a contractor is based on percentage of completion estimates of projects, the actual results of which will not be known until the projects are completed. "Phantom" profits or equity can disappear and leave the firm in financial distress.

5. POOR BUSINESS ACUMEN Many good builders are poor businesspeople. More and more business skills determine success. Financial management capability, marketing knowledge, business strategy and risk management are frequently lacking. Even good technical builders can go broke.

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6. POOR LEADERSHIP AND SUCCESSION Construction is a people business. Frequently, it is a "person" business because of the importance of a single strong leader. The most common denominator of success or failure of a contractor is the person leading the charge. The transition from a leader to the next generation is when many firms falter.

7. POOR FIELD PERFORMANCE Money is made and lost in the field. It is often said that great execution can overcome poor strategy. However, the wrong project manager or superintendent or turnover at those positions can spell trouble. Adequate project control systems are critical to identify problems early and make mid-course corrections.

8. PROBLEM OWNERS A difficult owner is frequently the downfall of a contractor. A poorly financed owner may lead to slow pay or no pay and create liquidity problems. Disputes resulting in claims, litigation and unsigned change orders leave the contractor in a poor negotiating position with substantial cash tied up in the project. That situation can spell bankruptcy. Customer selection is key.

UNCONTROLLABLE ISSUES

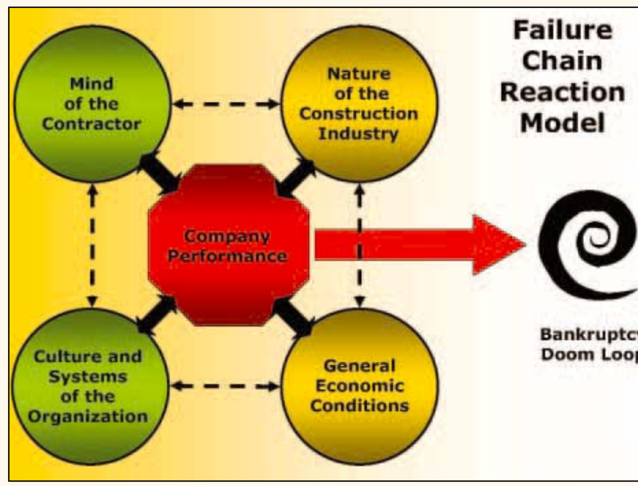
9. ECONOMIC VOLATILITY The construction market is currently very strong, which can lead to good times, overexpansion and failure. Downturns in construction tend to be sudden and severe and can catch the unprepared firm with too much overhead or precipitate taking very low margin work. Vigilance is necessary to avoid crashing aimlessly about on the waves of economic cycles.

10. CREDIT MARKET CHANGES Surety and banking credit are the lifeblood of the contractor. Changes in the underwriting standards such as those that occurred after 2001 can create serious difficulties for contractors who are pressing the outer limits of their credit availability. Several firms have had to sell or seriously downsize in the past few years because of unforeseen changes in the credit markets.

This list is only the beginning of the story. For every risk factor or cause of contractor failure there is a "cause behind the cause." For instance, a chain of failure could look like this:

BANKRUPT

FMI's ongoing research will evaluate 30 to 40 major contractor failures to determine the underlying causes and common themes. Perhaps by studying past failures, we



can help others be more successful.

In the meantime, the best advice we can give is to keep some "dry powder." Bad things happen to good contractors. Make sure the financial position of the firm is adequate to withstand the inevitable negative event so you can live to tell about it. Future success is predicated on being in business to take advantage of opportunities. ■

SURETY RESPONDS TO CITY'S EMERGENCY

Alarms will wail and sirens will sound from a new fire station in Huntsville, TX, thanks to the surety bond company's efforts to replace the defaulted general contractor.

Hopes for the new station on Daisy Lane were all but doused in August 2005 when the general contractor, Stephens Construction, failed to pay subcontractors and they walked off the job. In November, Stephens defaulted and its bond company, St. Paul Travelers, took over the partially finished project. In May 2006, the City Council approved the new contract with St. Paul Travelers' replacement contractor, Frost Constructors Inc., to finish Fire Station No. 1 on the town's growing west side.

The original contract was $1.2 million, and the new contract also is for $1.2 million—and that includes work already completed. However, the city won't lose any money, because St. Paul Travelers absorbs the difference.

"We're getting the fire station for the same price as originally bid, but we'll have a direct line to Frost," city attorney Thomas Leeper told the local newspaper.

The new contractor will correct some site grading and drainage problems, repair a broken roof truss and straighten some others and replace all of the siding.

As it was intended, the surety bond protected taxpayers' dollars and guaranteed the completion of the public project.

"I would just like to say the surety system has worked and the public interest was protected," Leeper told the local newspaper. ■

WHY BANKERS BOND: SPREADING THE RISK AROUND

The physicist Niels Bohr observed that it is possible to forecast anything except the future. In spite of such sage guidance, bankers have to do exactly that, assess the probability of default and the expected loss given default inherent in every borrower. To spread the risk around, especially in real estate development, bankers have a limited range of options—take on all the risk, some of it or none of it.

As a construction lender, a banker's goal is to be repaid on time, in full and as agreed. In turn, satisfactory repayment depends upon successful project completion, and that requires contractors, workers, material suppliers and others to honor their commitments by completing the tasks on time, in full and as agreed that they were contracted to perform. One way to mitigate the real estate construction risk and assure the successful completion of a privately owned construction project is by requiring bid, performance and payment bonds as conditions of the loan.

A banker's alternatives to bonding include letters of credit and self-insurance, but these options do not provide 100% performance protection and 100% payment protection, nor do they assure a competent contractor. A surety bond transfers the risk of contractor default from the project owner and lender back to the surety company. The purpose of the bond is to protect the third party, the owner and, indirectly, the owner's lender, from exposure to loss.

> **"One way to mitigate the real estate construction risk and assure the successful completion of a privately owned construction project is by requiring bid, performance and payment bonds as conditions of the loan."**
>
> —Dev Strischek, SunTrust Banks

ADVANTAGES OF BONDING

When analyzing the risks on a particular project, such as project scope and complexity, contract dollar amount and familiarity with the contractor, consider how surety bonds protect against those risks. When a reputable surety company bonds a contractor, owners and bankers are protected on many fronts because:

- The contractor has undergone a rigorous prequalification process and is judged capable of fulfilling the obligations of the contract;
- Contractors are more likely to complete bonded projects than non-bonded projects since the surety company may hold personal or corporate indemnity;
- Exposure of mechanics' liens by unpaid subcontractors and suppliers is transferred when a payment bond is in place;
- The surety has claims paying strength;
- Surety companies may offer technical, financial or management assistance to a contractor to prevent default;
- Risk concentration and lender liability is reduced; and
- The surety company performs the obligations of the contractor in the event of contractor default.

SURETY DIRECTORY

SURETY DIRECTORY

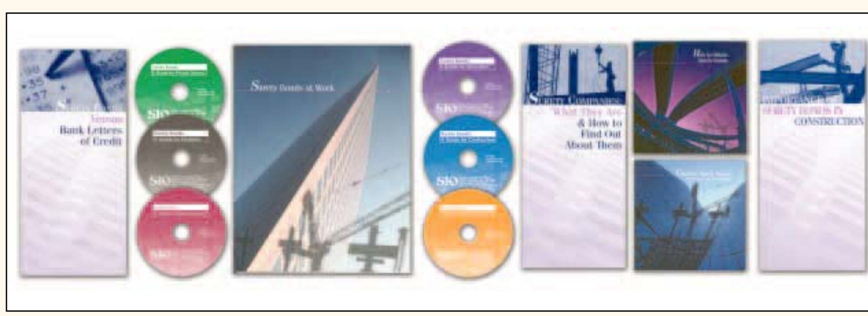
Any contractor, whether in business for one year or a century, large or small, experienced or novice, can experience serious problems. Through the years surety bonds have held fast as a comprehensive and reliable instrument for minimizing the risks in construction.

Movie mogul Samuel Goldwyn used to remind his studio heads that a verbal contract isn't worth the paper it's written on. That's why bankers talk to their borrowers about the importance of written loan agreements, and in construction lending, about the importance of written bonds. After all, the surety examines a contractor much the way the banker does. Before issuing a bond or extending credit, both the bonding company and the commercial lender must be satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly and meets obligations on time, as agreed, and in full.

Liquidity and availability of capital at risk is more important than ever when obtaining surety bonds. One of the advantages of requiring payment and performance bonds is that a qualified contractor and project completion are assured without drawing on the contractor's line of credit. In effect, bonding capacity is a credit enhancement and a viable alternative to the banker taking on all the credit and construction risk. ■

SIO: THE INFORMATION SOURCE FOR CONTRACT SURETY BONDS

The Surety Information Office (SIO) is the information source for contract surety bonds in public and private construction. Whether you are a construction project owner, lender, contractor or design professional, SIO's free brochures, CDs and PowerPoint® presentations clearly explain surety bonding. Materials include:



- **CONTRACT SURETY BONDS: Protecting Your Investment** Provides compelling facts about the value of surety bonds on private construction projects;
- **WHY DO CONTRACTORS FAIL?** Outlines the events that lead to contractor failure and the warning signs that a contractor is in trouble;
- **SURETY BONDS AT WORK** Includes case studies detailing how sureties prevent and resolve claims;
- **IMPORTANCE OF SURETY BONDS IN CONSTRUCTION** Provides an overview of the value and benefits of contract surety bonds;
- **SURETY COMPANIES: What They Are and How to Find Out About Them** Explains how easy it is to qualify a surety company through readily available resources; and
- **AN OVERVIEW OF THE CONTRACT SURETY BONDS CLAIMS PROCESS (AGC)** Addresses performance bond default situations, payment bond claims and project owner expectations.

Information is also available on interactive CDs. Titles include:

- Surety Bonds: A Guide for Private Owners
- Surety Bonds: A Guide for Public Construction
- Surety Bonds: A Guide for Contractors
- Surety Bonds: A Guide for Students

View, download or order free materials via the SIO Web site at www.sio.org, or contact Marla McIntyre, executive director, at (202) 686-7463 or mmcintyre@sio.org. ■

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SIO is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles, and answer questions on contract surety bonds. SIO is supported by The Surety Association of America (SAA) and the National Association of Surety Bond Producers (NASBP). All materials may be accessed at www.sio.org.

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