Insurance II – Surety

Surety Bonds

The assurance taxpayers, contractors, and owners need in an uncertain construction market

What's Inside

SURETY MARKET OVERVIEW

By Stephanie Robichaux

As the United States recovers from the economic downturn, construction opportunities lag behind, due mostly to the lack of public spending. The nation's unemployment rate was 6.3% in May, down from 7.5% from May 2013, according to the U.S. Department of Labor. The construction industry is slower to recover, though, with an unemployment rate of 8.6% in May, an improvement from 10.8% at the same time last year. With consumer confidence and private spending on the rise, surety executives are hopeful about the next few years.

"We are seeing growth in employment, interest rates are still at historic lows, and banks are lending money. Disciplined contractors are succeeding, and the construction economy appears to be bottoming out or even showing some pockets of improvement," says Tom Kunkel, CEO of Travelers Bond & Financial Products. "The surety industry has seen some elevated loss activity, but it does not appear to be affecting capacity across the industry, as good contractors still are able to obtain bonding."

Small

Small contractors were hit hardest by the recession, and while the market remains competitive, there is adequate capacity for qualified contractors. "Small contractors must demonstrate a commitment to bid the work and not the competition," says Josh Penwell, vice president of contract underwriting at Merchants Bonding Company.

A number of surety bond companies specialize in marketing bonds to small contractors. In addition, several major surety bond companies have initiated programs to bond more small contractors. Many surety bond companies have designed special strategies that encourage their producers and underwriters to seek small contractor business. "A number of surety companies are well-positioned to support smaller contracting businesses. This segment of the market remains competitive because the barriers for entry, for both sureties and contractors, are the lowest in the industry," says Michael Cusack, managing director of Alliant.

Many surety companies offer fast track programs designed for small or emerging construction contractors with a simplified application process and less stringent requirements for obtaining a bond. "For very small contractors, approval can be quick with limited information," says Rod Williams, chief underwriting officer at Liberty Mutual Surety.

Middle

Contractors in this segment of the market were hit hard by the recession and lack of public construction spending, but those contractors with strong balance sheets will find plenty of surety credit in the middle market. "Capacity in the middle market is abundant, as most public works contractors are not seeing a significant amount of work to bid, which is keeping backlogs down," says Larry Christianson, assistant vice president of contract surety at The Hartford. This market segment could become more competitive as well. "While there is plenty of surety capacity for contractors operating in the middle market, the industry has experienced several new entrants over the last few years that could bring increased competition," says Stephen C. Ruschak, president and chief operating officer of The Guarantee Company of North America USA.

Surety executives say that they are focused on making sure that these contractors have the ability to grow as the market improves, especially since some contractors are taking on more complex projects or expanding outside their geographical area of expertise.

Large

"Large contractors continue to experience terms and conditions consistent with a profitable industry that has strong reinsurance support. Surety companies are, however, seeing some problem projects and liquidity burn," says Doug Wheeler, regional managing director for the Mid-Atlantic at Aon Construction Services Group. Well-managed firms will not have a problem finding surety capacity to meet their needs.

"Many well-run firms have created a strong market niche where they can thrive because of their knowledge and expertise. A recent trend is the move to joint venture work as projects get larger and firms need to partner in order to create the necessary capabilities to acquire work," says Mike Bond, head of surety at Zurich.

Mega

"The credit quality remains high for contractors in the mega market, and opportunities for work are increasing," says Liberty's Rod Williams. "There continues to be more than adequate surety capacity for the mega firms. The surety cap on the penal sum of larger bonds continues to escalate. It was common to see a cap of $250 million five years ago. That liability limitation threshold is now over $1 billion for jumbo jobs," says Alliant's Cusack.

New project delivery methods, such as public-private partnerships, have become more common in the mega market. Surety executives say that this is presenting both opportunities and challenges for contractors and sureties. "The largest contractors typically have strong diversification of revenue and resources to manage challenges that may develop. This is important since this market area has the fewest surety companies that can fluently provide large single bonds," says Aon's Wheeler. The mega market remains attractive for the handful of sureties that can write bonds for these projects.

Contractor Failure & Value of Surety Bonds

"Contractor loss experience continues to be concerning. Despite more available work, contractors are seeing lower margins and have yet to down size their firms in anticipation of more work coming during 2014," says Robert Staples, senior vice president of North American Surety at Allied World.

Every year thousands of contractors, big and small, face bankruptcy and business failure. According to BizMiner, approximately one in four contractors fail. "Surety bonds are the only form of security that can effectively prequalify contractors and assure the contractor's performance and payment obligations, as well as a lien-free asset. These protections are even more critical due to jobs becoming larger, an increasing number of failures coming out of the economic recovery, and riskier jobs as contractors bid on work with low profit margins," says Rick Ciullo, chief operating officer of Chubb Surety.

Doug Hinkle, chief underwriting officer at CNA Surety, says that "while contractor profit margins and operating results vary by territory and niche, for those contractors in our book of business that have struggled with operating losses, there has been a consistent improving trend in operating results over the past three years." Surety executives agree that well-managed contactors that adjusted overhead and expenses during the recession are set up to succeed during the economic recovery.

As the economy improves and contractors often are tempted to expand outside their areas of expertise, surety bonds are going to be as critical as ever. "As opportunities to pick up work increase, many contractors may not have the liquidity or other resources needed to prosecute an increase in work, and they may not have the discipline to either decline opportunities or seek higher margins. Sureties are in the best position to analyze these contractors, know their strengths and weaknesses, and control their appetite for increased work. A surety should also know if a contractor is getting too stretched out on other work before an owner or general contractor would," says Liberty's Williams.

The Guarantee USA's Ruschak agrees. "With the possibility of contractors overheating as the economy improves, it would be prudent for owners and general contractors to require performance and payment bonds. The sureties have demonstrated an excellent ability to support contractors capable of successfully completing contracts. The industry also recognizes they must provide responsive claim handling duties in the event that a bonded contractor has difficulties in completing its contractual obligations."

One of the benefits of bonds is the surety's prequalification service. "Surety underwriters are trained to evaluate the risks associated with various contractors, and also determine the appropriate levels of projects and programs that a contractor should undertake. The premium charged for this service is more cost effective and efficient than attempting to handle this internally," says Merchants' Penwell.

"I am constantly amazed when I hear an owner question the value of surety bonds and, in the same sentence, remark that the owner has never had to claim against any of its bonds. I always respond to the owner that that is precisely the point of surety bonds—you are receiving the benefit of the sureties' extensive prequalification process...the point is to not have a claim," says Tom Padilla, senior vice president of HUB International Insurance Services, Albuquerque, N.M., and president of the National Association of Surety Bond Producers.

Sureties prequalify contractors that, in the surety's opinion, have the capacity, character, and capital to complete the contract. Sometimes, though, problems occur, and contractors default. From 2002-2013, surety companies paid over $13 billion in claims, plus additional billions for claim expenses. Many times, however, the surety steps in even before a contractor gets into a default situation. The project owner may not even be aware of these services. Many times, default is averted because of the surety company's expertise in seeing projects to completion.

When a contractor gets into trouble, the surety may provide trained personnel with experience and expertise in handling crisis situations—such as engineers, construction management specialists, accountants, etc., can pay subs and suppliers to keep the job moving forward and keep parties familiar with the project involved, and may also offer financial assistance to the contractor to reverse cash flow problems.

The Hartford's Christianson says, "Having the protection of a surety, which can take over in the event of a default, complete the job [according to the contract], and pay subcontractors, vendors and suppliers, is a smart business practice."

Surety Outlook

Optimistic about the future of the surety and construction industries, surety executives still expect losses to increase in both severity and frequency, especially among special trade contractors and subs. "Margins have been too low in recent years, and risks remain high, so naturally some firms will experience problems obtaining surety. Overall, surety capacity will remain strong because construction firms have become more sophisticated as a result of the economic downturn and are better able to manage risk," says Zurich's Bond. "We do not expect capacity to be reined in, however we do expect to see sureties continue to re-underwrite what they have and remove those firms that do not meet more robust underwriting standards on a going forward basis," says Allied World's Staples.

There will remain few options in the public construction arena for the foreseeable future, but an uptick in the private market should create some opportunities. "Despite stagnant public construction spending, the overall construction market continues to move forward with growth being largely in private residential," says CNA's Hinkle.

In parts of the country where private spending has picked up, some surety executives say they are seeing an increased use of bonds on private projects. "We have seen an increase in demand for surety bonds in private construction mostly driven by bank requirements for bonds as a condition to provide project financing," says Henry W. Nozko, Jr., president of ACSTAR Insurance Company.

"I think lenders increasingly understand the importance of surety bonds to backstop privately financed projects," says HUB's Padilla.

Merchants' Penwell says, "Sophisticated general contractors and risk-averse private owners understand that payment and performance bonds are a cost effective and efficient way to mitigate the risk of contractors and subcontractor failure."

"History indicates that recovery periods can be fraught with hazards to contractors and sureties, as safety, productivity, and cost inflation of labor and materials can erode still recovering margins," says Travelers' Kunkel. "Notwithstanding these challenges, with the improving economy, we continue to be optimistic about 2014 overall." ■

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EXECUTIVE VIEWPOINTS 2014

***Q.** What are the benefits that surety offers owners and contractors on P3s that other risk management tools do not?*

Tom Kunkel
CEO
Travelers, Bond & Financial Products

National, state, and municipal governments are increasingly turning to public-private partnerships (P3s) as a procurement method. To protect their interests and assets, it is important that construction companies engage the expertise of an experienced surety and agent to discuss effective bond solutions.

Bonding offers clear benefits that other risk management tools do not. One clear benefit of bonding is that bonds, subject to terms, help assure that a project is completed. This is in the concessionaire's and owner's interest, as well as that of the public user. Other forms of security may simply make available a smaller sum of money in case of default, which is different from assuring completion. Also, nearly all P3 projects are on public property, and, therefore, subcontractors and suppliers have no lien rights in the event they do not receive payment. A payment bond provides this protection, which is important because large P3 projects employ smaller local contractors whose ability to withstand non-payment is limited. Finally, because a surety generally underwrites many projects in a contractor's backlog, the surety is incentivized to be satisfied that the design-build contractor has the skills and experience to complete the work.

There are different stakeholders in P3 projects, and it is therefore important that construction clients engage their agents, brokers, and surety in discussions in order to help them come up with workable solutions that will protect their interests and their assets. The value added by these surety industry partners should not be underestimated.

Mike Bond
Head of Surety
Zurich

P3 projects are growing in use in the United States as more and more owners look for unique approaches to deliver much needed infrastructure improvements. Surety companies perform a valuable but often underappreciated service in that they prequalify construction firms for the job. P3 project are often by definition highly complex and require specialized expertise from the construction community. Sureties put their own capital in support of construction companies in the form of surety credit and are highly experienced in identifying construction companies and their capabilities. In most cases, contractors partner with other construction firms, and the availability of surety credit often helps a contractor to join with another highly qualified firm to secure work that the contractor cannot secure on its own. Of course subcontractors and suppliers, many of whom are small businesses, operate under the protection of the payment bond to make certain that they will get paid in a timely fashion for their work and supplies. Finally, the taxpayers enjoy the performance guaranty for the design-build phase of the project in an industry with a high rate of default. Surety bonds help to make sure the project is delivered to the benefit of the ultimate consumer.

Rick Ciullo
Chief Operating Officer
Chubb Surety

When big money is at stake, project owners, lenders, subcontractors and suppliers want certainty. Performance and payment surety bonds can be good tools to help manage construction risk.

Contractors are prequalified during the surety underwriting process. As a result, only contractors that the surety believes have the capital, capacity, and character to perform the work will be able to provide surety bonds to protect the owner, lender, subcontractors, and suppliers. A performance bond guarantees that the work will be carried out in accordance with the terms of the bonded contract; a high penalty bond of 50% to 100% of the contract value can offer the right protection in the right monetary amount to help ensure that the project is completed. Additionally, a payment bond of 50% to 100% of the contract value helps ensure that subcontractors and suppliers who furnish labor or materials to the bonded contractor on the project are paid—this protects subcontractors and suppliers and can also provide the owner and lender with a lien-free asset.

Bank letters of credit (LOC) can provide short-term liquidity in a project emergency, but the underwriting process does not prequalify the contractor. Moreover, since the LOC is typically in the amount of only 10% of the contract value, it does not ensure that the asset is built and lien-free.

Contractors may also find surety bonds to be a better risk management tool. Unlike a LOC, surety bonds do not reduce the contractor's bank borrowing capacity and are less susceptible to being used as leverage against the contractor in a contract dispute with the owner.

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Stephen Haney
Division President, Surety & Chief Underwriting Officer, Global Surety
ACE Group
Chair of SFAA's Board of Directors

Payment and performance surety bonds reassure the sponsor in a public-private partnership (P3) that a lien-free project will be provided by a contractor whose past work history has been reviewed and who was successfully prequalified by an experienced surety underwriter. Upon completion of the P3 project, requiring a bond on the operations and maintenance phase ensures that the project will operate as specified in the documents set forth in the P3 project.

The surety works as a partner with the contractor and brings value to the sponsor by helping the contractor address job-related issues as they arise. The surety is another onsite resource that shares the owner's goal of executing the project in a safe and timely manner.

P3 projects are highly visible in their local geographies. Having the benefit of an experienced surety helps ensure you enlist responsible contractors of all sizes. In short, a surety can help make your project a success.

Constantin Poindexter
President & Chief Underwriting Officer
Surety One, Inc.

The public-private partnership (P3) concept was a result of the government's struggle to accomplish important public projects in the face of diminishing revenues. A P3 is a contract that allows a private entity to perform work traditionally done by government agencies. P3s work for many reasons. They offer more efficient completion of projects, nullify the public entity's need to incur debt to finance them, and give the public entity access to qualified professionals in the field. The trade off is a lack of transparency regarding the financial condition and capacity of the private partner.

From my perspective, surety bonding involving both the contractor and private partner is essential. Regardless of the contract that it enters into with a private enterprise, a public entity is responsible for providing essential services and facilities. If the P3 fails, the taxpayers will eventually shoulder the burden. Historically, the contract surety prequalification process has proven itself to be an excellent element of construction risk management strategy. In the case of a private partner that engages in investment, finance, or other non-construction activities, the prequalification process becomes even more valuable to the public. A public entity can never know a bonded principal or have the same depth of relationship with him or her that a surety company does. In the case of a failure by the private partner or contractor, the public is further protected by the financial strength/creditworthiness of the surety company as well as the surety company's expertise in the coordination or completion and remediation.

Q. How does the surety's prequalification process differ from an owner performing its own prequalification?

Larry Christianson
Assistant Vice President of Contract Surety
The Hartford

The surety prequalification process involves an in-depth analysis and interview process. In most cases, the surety has a long-term relationship with the contractor. The surety underwriter has been meeting with that contractor over an extended period of time, discussing its individual job profits, internal cost systems, business plan, and overall business practices. An owner may have similar expertise to prequalify a contractor, but it is unlikely to have the time, resources, or access to the same information that a surety reviews.

Doug Hinkle
Chief Underwriting Officer
CNA Surety

It is not unusual for owners to have established some prequalification processes for contractors doing work for them. In those instances, the prequalification process can range from being a very basic credit check to a more thorough capital, capacity, and reputation analysis.

In contrast, the surety is in the business of providing bonds and the prequalification process is the very essence of what surety underwriters do for a living. A surety bond provides very broad coverage at significant risk to the surety. As a result, surety companies allocate significant capital to their business to absorb potential loss and to insure that they have the systems, expertise, and staff necessary to provide an in-depth analysis of all aspects of the business operations of the contractor on an ongoing basis.

Most owners don't have the resources nor would choose to invest the resources that would replicate what a surety company invests as a part of its ongoing business needs. As a result, the quality of the prequalification process is much higher with a surety.

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Doug Wheeler
Regional Managing Director, Mid-Atlantic
Aon Construction Services Group

The surety industry has decades of experience in measuring contractor operational and financial capabilities. Surety underwriters spend a considerable amount of time analyzing project cost data. This level of analysis is designed to illustrate trends that can identify potential problems with future cash flow. Many owners don't have the resources or experience to perform this level of due diligence.

Another key consideration is the amount of information that contractors share with surety partners. Surety companies typically are in receipt of timely updates that may include other related businesses and/or personal investments, which could have an impact on the contracting business. This is part of a typical prequalification process. If an owner is not aware of these outside financial considerations, they may not have insight into potential problems.

Surety companies also receive independent status reports on other bonded projects. They may become aware of project issues or subcontractor payment concerns well before these problems manifest on typical financial presentations.

Lastly, surety underwriters endeavor to support contractor backlog at a level that is sustainable to manage all work in a professional manner. Owners may not be aware of pending bids or contracts. Rapid backlog growth can spread resources and increase risk.

Thomas M. Padilla
Senior Vice President
HUB International Insurance Services
Albuquerque, N.M.
NASBP President

I've encountered owners that sometimes harbor the mistaken belief that an alternate prequalification of a contractor serves as an adequate substitute for the requirement of performance and payment bonds on a contract. The owner's prequalification is an important risk tool; however, it general only focuses on the contractor's qualifications at a single point in time. It is not a comprehensive and continuous view of the contractor's overall program.

Sureties focus on deep, long-standing relationships with their construction clients, getting to know them in a way that public officials and others will not be afforded the time and resources to do. Sureties go through a thorough process looking at all aspects of the contractor, including its financial resources, management capabilities, reputation, business plans, continuity plan, and experience. In addition, a surety analyzes and underwrites a contractor's entire work program including all jobs bonded and unbonded. This is a continuous process that cannot be replicated by a public contracting agency. Sureties prequalify contractors every day, then monitor those contractors throughout the entire duration of their construction projects. Moreover, the surety provides a knowledgeable and financially capable third party to guarantee the performance of the construction firm. This guarantee is essential to protect against the catastrophic financial risk that the owner faces on each project. In the unlikely event of a default, the surety brings to the table considerable expertise and resources to make sure obligations are fulfilled. Additionally, in many cases the surety steps in with resources to keep a contract on track and avoid a default or any other payment issues before they happen.

Robert Staples
Senior Vice President, North American Surety
Allied World

Expertise. Construction is a precarious business and financial credit analysis is not an owner's primary function. While the owner is responsible for the bid process it should delegate its prequalification process to reputable sureties as a part of its overall risk avoidance practices.

According to Alexander Pope, "A little learning is a dangerous thing." Simply put, there is far more behind the numbers that an owner will not have access to in comparison to a surety's prequalification analysis. Most owners that engage in prequalification practices simply check credit reports such as Dun & Bradstreet, talk to familiar subcontractors or suppliers for reference, and then apply the results of a financially derived formula to reach a "prequalified work program" number.

Why would an owner take on additional risk through a rudimentary prequalification process performed on its own when it can engage with sureties that do it for a living? Owners build; sureties prequalify contractors and support their decisions through performance and payment bonds. Let's take some of the riskiness out of the process by allowing the experts to focus on what they collectively do best.

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Michael Cusack
Managing Director
Alliant

A surety's prequalification process is far more comprehensive than a project owner's review of a contractor's qualifications. While project owners will normally review a contractor's past relationship with the owner, its completed work history, available project team, a firm's reputation, and financial qualifications, the surety underwriting process is a much deeper dive into a contractor's business.

The surety underwriting process will consider the same areas owners would typically review as outlined above, but then expands the examination to include a review of under-billings, claims, exposure on outstanding litigation, open jobs that have concerning operational issues, subcontractor risk mitigation process, cash flow, margin expectations, job borrow, problem accounts receivables, management continuity, available bank support, and parent company commitment, if applicable.

Additionally, if the sureties have been engaged with an account for a number of years, there's a reasonable chance that the sureties can point to examples of how the contractor's ownership and management team deal with adversity. The surety's experience and long-term relationship with a contractor give the bonding company confidence in knowing how a contractor will react to stressful situations and major economic or operational challenges. Will a contractor have the perseverance, determination, and integrity to push through challenges and maintain the quality of its work and the stability of its relationship with owners and subcontractors? In this context, the surety's longer-term relationship with a contractor and experience with and knowledge of how a firm responds to challenges is a critical, yet intangible, aspect of prequalification that most owners' prequalification criteria may not capture.

***Q.** What are the benefits to a general contractor of subcontractor bonds?*

Fran McGrath
Contract Chief
Underwriting Officer
Liberty Mutual Surety

Coming off of the recent economic and construction recession, balance sheets of the contractor community, particularly subcontractors, have been strained by lower volume, decreased profit margins, and poor cash flow. Paralleling economic recovery and the rise in stock prices, construction volume is gaining momentum. During a period of recovery, historical data indicates the highest number of contractor failures to occur and the need for subcontractor bonds never greater.

Prior to the issuance of the bond, the surety prequalification process provides significant value and confidence to the general contractor that a subcontractor has the financial and operational wherewithal to complete the scope of work. Sureties typically have access to information not available to general contractors. Specifically, this includes the ability to assess estimating capabilities, internal controls and accounting systems, problematic projects, slow turning receivables, and financial statements of related parties and individual owners. The surety prequalification process also diminishes the possibility of a subcontractor taking on too much work or work they are not qualified to perform. The issuance of a bond eliminates potential risk of a general contractor making double payments to second-tier subs and suppliers that may lien a project. Lastly, responsible sureties will work diligently to get the project completed timely and according to the contract if called upon.

Stephen C. Ruschak
President & COO
The Guarantee Company of North America USA

The prequalification of the subcontractor that the surety provides to the general contractor is one of the most valuable benefits of requiring subcontractor bonds. Despite having a long track record with a particular subcontractor, problems or internal issues and changes with the subcontractor can still arise that may not be evident to the general contractor. The surety, however, is often aware of such issues which could affect the performance capacity of the subcontractor, or its ability to pay its own subcontractors and suppliers. By requiring subcontractor bonding, the general contractor gains the expertise and the detailed knowledge that the surety brings to the prequalification process.

Josh Penwell
Vice President
Contract Underwriting
Merchants Bonding Company

Managing construction project risk is critical for its success. Requiring payment and performance bonds

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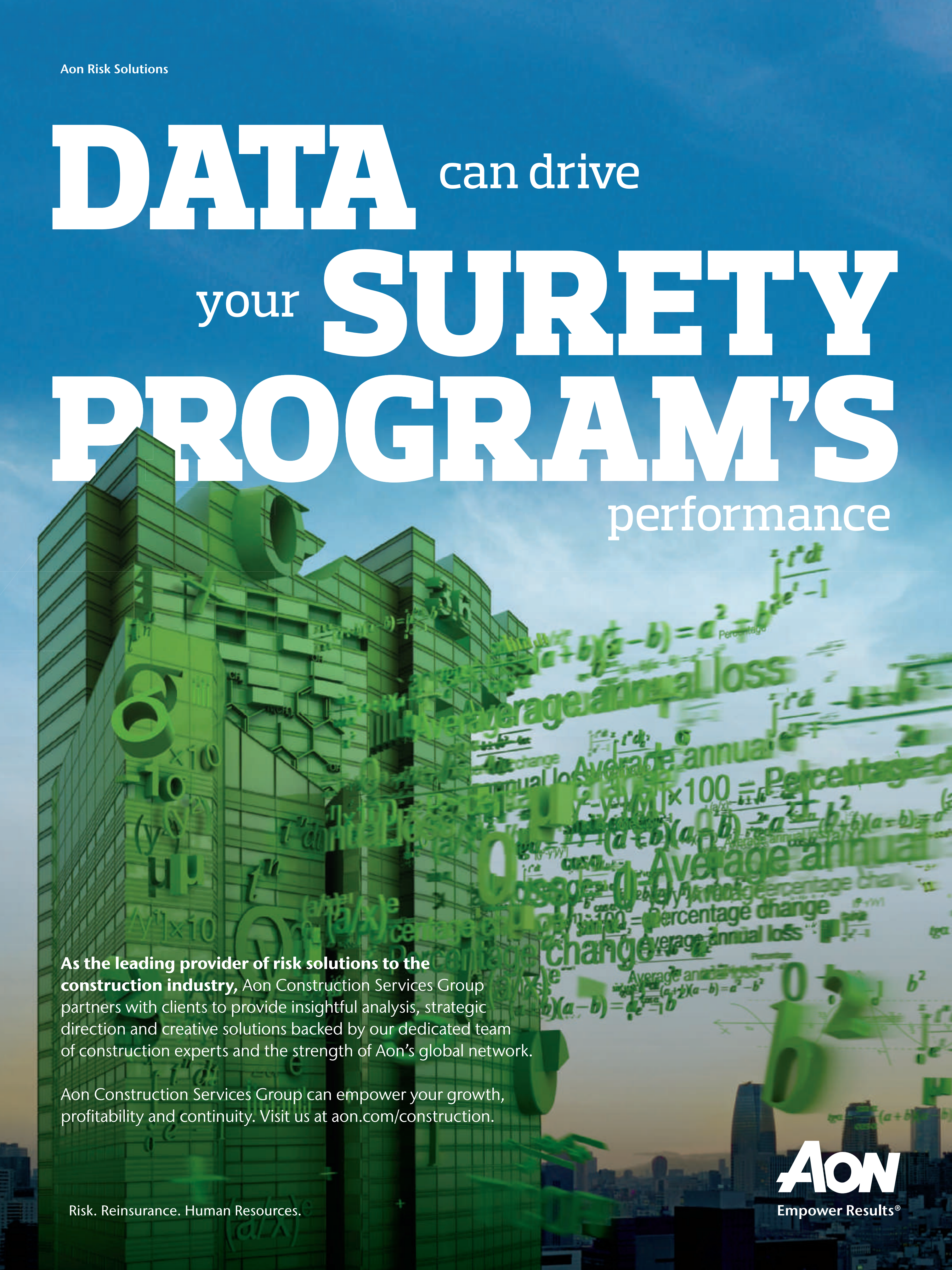
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from subcontractors is the most cost effective and efficient way to mitigate the risk of subcontractor failure. Specific benefits bonds provide are:

- Surety underwriters are trained to evaluate the risks associated with contractors and determine the appropriate levels of projects and programs that a contractor should undertake. The premium charged for this service is more cost effective and efficient than attempting to handle this internally.

- The payment bond provides protection against subcontractors and suppliers who could lien the project if they don't get paid. It also mitigates the exposure from second-tier subcontractors, suppliers to subcontractors, and union dues.

- Subcontractors are motivated to fulfill their obligations on bonded projects since they typically provide personal indemnity to the surety. A troubled subcontractor is more likely to perform well and complete bonded jobs since personal assets are often at stake.

- Performance and payment bonding ensures that project owners, architects, lenders, and end users are satisfied. It saves substantial overhead expenses in legal fees, time spent on non-productive issues, and sending unnecessary correspondence.

- A bonded subcontractor has a professional agent and surety to assist in fulfilling its other obligations.

Henry W. Nozko, Jr.
President
ACSTAR Insurance Company

The benefit of subcontractor bonds to general contractors is very compelling under the current market conditions of the non-residential industry. During 2013 the U.S. non-residential construction business remained in a deep slump. According the U.S. Census Bureau, the seasonally adjusted annual rate of non-residential construction declined further during 2013 to $560 billion compared to $564 billion in 2012, continuing a prodigious fall since the financial meltdown in 2008. Back then the annual rate of non-residential construction was over $700 billion. Through this period of decline, contractor profit margins have eroded and balance sheets have weakened causing a rise in subcontractor defaults. Based upon historical data, we may not see any improvement for a while. For example, a recovery of the residential construction industry historically has preceded a recovery in the non-residential construction segment by one or two years. Gross issuance of fixed rate mortgage backed securities during the first quarter of 2014 was 60% lower than the first quarter of 2013, suggesting a stall of improving conditions for the residential construction market. If history repeats, that will back up any recovery in the non-residential sector. According to The Surety & Fidelity Association of America, surety losses are on the rise, most likely caused by the poor market conditions prevailing in the construction industry.

The default of a significant subcontractor that is not bonded could turn a profitable contract for a general contractor (GC) into a loss of profit and loss of reputation. With the potential for a rise in the number of subcontractor defaults, it is hard to make the case that a GC should expose itself to the expenses associated with a subcontractor default as compared to transferring the growing potential risk to a surety that is in the business to accept and manage such risks. During these economic times, saving a subcontractor bond premium could wind up being penny wise and dollar foolish.

W. Milton Smith, CIC, CRIS
Senior Vice President
McGriff, Seibels & Williams

Many contractors mistake bonding subs as either "double bonding" or an unnecessary cost. This could not be further from the truth. The general contractor's (GC) bond protects the owner from the GC's performance default and protects the subcontractors and suppliers from a payment default. In order for the GC to insulate itself from similar risks arising out of subcontracted work, it is critical that the GC require performance and payment bonds from its subcontractors. The sub bond protects the GC's interest in the sub's performance under the contract as well as the payment risk to the sub's suppliers and any second-tier subs. Without the bond, the GC's profit is exposed to sub default.

As the market begins to show signs of recovery, it is critical that GCs take a hard look at bonding their subs. As an industry, we see the majority of sub defaults occur in an upswing following a recession, as capital and resources have been depleted by the economy. Due to the fact that the most recent downturn in the construction market has lasted as long as it has, bonding subcontractors is as important to a GC as it has ever been. ■

Reinvention During Recovery: Do or Die

By Therese Wielage

The hard truth for contractors is, like all businesses, they need to reinvent themselves or eventually die. The Harvard Business Review calls it the "Reinvention Imperative" and claims that only 10% of businesses recover once they start to stall. Those contractors that survived the recession are now in the middle of the long, slow recovery; and if they have not begun to work on reinvention, now is the time.

Reinvention is the intentional updating of a company's capabilities, service and operations, and marketing and communications in anticipation of changes in the marketplace. Timing is crucial. Things often are rosiest in the life cycle of a company just before the decline begins, making it difficult to recognize the need for change; or like many contractors, your company is recovery-weary from being in survival mode for so long. It may be difficult to see the way ahead and there's fear about investing meager resources. But, the ability to jump to the upslope of the next cycle and avoid the downward spiral comes from the discipline of constantly working on reinvention. If you're always working on it, you're always ready.

"We lost our discipline and started to slide again," said Doug Pruitt, former CEO of Sundt Construction, at a gathering of surety agents and underwriters. "We worked hard to bring the company back from the brink of disaster, motivated by the drive to save the company. As things got better, we started to get too comfortable and we knew from experience what happens when you get too comfortable."

Pruitt, and other veterans of the construction trenches, promote focusing on the three things that help you constantly reinvent your company and sustain high performance.

1. Always be updating your capabilities, investing in innovation, knowing that some initiatives will fail.

2. Invest in your people. Train them to keep a ready supply of talent for today's business and succession planning for tomorrow's.

3. Maintain a disciplined focus on running the business by planning, executing, evaluating and modifying in a constant cycle. Find success because of your actions rather than having success happen to you by accident.

"While the industry has been waiting patiently for the economy to recover, many of our contractors implemented solutions focused on bottom line performance. They reduced overhead and invested in developing new markets," said Jorge Mendez who heads up USI Insurance's surety operations in Phoenix, Ariz. "The result has been significant increases in their bond programs. One client completed an $80 million project, which was a 400% increase over the next largest bonded project for a new owner in a new market."

Mark Keairnes, head of surety for Lamair Mulock Condon in Des Moines, Iowa, said, "We are seeing two trends in contractors reinventing themselves—the use of Building Information Modeling (BIM), especially as a selling point with private owners, and gone are the days of the gruff, hard-driving job foremen or iron-fisted project managers running roughshod over subs and telling off owners. They are not what customers want. Customers want a kinder, gentler approach. They want an ambassador to walk them through the project explaining what will happen in week one, week two, and so on." Clearly those two trends work in concert to help contractors win the work. BIM allows them to build the project virtually and show the owner how they'll build it and can be used throughout a project to keep up good communications with the owner.

While contractors look to technology and friendlier service to update their capabilities and operational efficiencies, they also need to reinvent how they find and develop talent. Human resources experts say the focus must shift to analyzing employees' potential for learning new things, rather than focusing on their experience. The military even has an acronym-turned-buzzword for it, "VUCA," which stands for volatile, uncertain, complex, and ambiguous environment. Researchers report that in VUCA, competency-based appraisal and promotions are insufficient. What makes someone successful in a particular role today might not tomorrow if the competitive environment shifts, the company's strategy changes, or he or she must collaborate with or manage a different group of colleagues. So the question is not whether your company's employees and leaders have the right skills; it's whether they have the potential to learn new ones.

Leaders in the construction industry are continually faced with complex changes including an aging population, lack of skilled labor, and constant technological advancement. Research shows in a shifting environment, consistent business performance is not enough to perpetuate itself. To keep their organizations relevant, CEOs and other leaders must heed the reinvention imperative.

One business expert put it this way: What contractors who survive will learn and have been learning is that they must get beyond the pride of "what they are really good at" so that it does not become the ball and chain of "the way we've always done it." Any company that fails to adapt to the markets of the future will find itself on a treadmill, trying to keep one step ahead of the steadily declining margins and profits of yesterday's business. ■

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Not Inviting Surety Claims to a Meeting with the Owner? Think Again.

An outstanding surety claims team proves its real value during pre-claim resolutions.

By Adrian A. Braganza

In the past, "Stay away from the surety claims department!" was the unwritten rule among contractors. Any contact with the claims department was thought to put contractors in a negative light with its surety.

The construction industry in recent decades has grown more complex and its disputes have followed suit. The surety bond claim process as an integral part of construction industry has adapted to these changes and can be a great resource to contractors competing in this new environment.

Today, forward-thinking surety claim departments play an expanded role in the dispute resolution process beyond being simply a vehicle for paying or denying claims, as was the case in the past. The surety claim departments of most major sureties like Zurich have become an important resource to contactors by assisting them in resolving disputes *even before a formal claim is filed.*

Benefit of Early Surety Involvement

Therefore, the "rule" that general contractors should follow is to seek surety claims involvement if a dispute cannot be resolved directly with the owner early in the process. Simply put, involving the surety claims team before a dispute becomes intractable may help avoid a formal claim being filed by the owner and reduce costs for all parties involved. However, any input from surety claims is not meant to replace the advice of in-house or external counsel but rather to supplement that expertise.

The volume of claims handled by a large surety bond provider necessarily results in the accumulation of a tremendous amount of experience in dealing with a wide range of performance and payment disputes. This experience lends itself to providing effective and efficient alternatives when problems arise. Think of a sophisticated surety claims team as being able to offer both the hard and soft skills necessary to assist you, including the expert knowledge of the surety bond claim process together with the experience developed in having helped resolve numerous past disputes.

Pre-claim Resolutions Keep Projects Moving

Many construction projects go smoothly but others face unexpected bumps along the way. The primary goal of resolving a performance dispute before a claim is filed is to keep the parties working together in order to stay on track with the project's budget and schedule. A skilled surety claims team can help an owner and general contractor avoid an impasse and the costs in time and money of a potential default.

Some key intersections where an experienced surety claims team can add value are:

1. Acting as a mediator or referee to help both sides better communicate with each other and help avoid the escalation of a dispute.
2. Providing reassurance to the owner that another stakeholder is monitoring its project.
3. Educating both the general contractor and owner about costs and risks of delays, i.e. finish the project and fight later.
4. Suggesting short-term solutions to problems, i.e. involvement of a consultant to monitor project.
5. Alleviating the owner's concern over payment bond claims being received.
6. Providing training on how the bond might affect the general contractors coexisting liability under its contract.

Negotiation in Action

Example 1

A large contractor having expanded into a neighboring state ran afoul of the owner early in the project. At a meeting with the owner, it became apparent that the contractor was facing possible termination despite having resolved or addressed most of owner's complaints. With the principal's agreement, an off-the-record meeting was then held between the surety and the obligee's representatives, during which they discussed alternatives to termination. The principal, when apprised of the owner's position, decided to hire a local contractor as a subcontractor to complete the project. The surety did not hear further from the owner.

Example 2

A medium size general contractor was retained by a construction manager (CM) at-risk to build 30 apartment units in an existing community. Late in the project, the surety received notice from the CM advising of the principal's failure to perform. The principal, confident that it would prevail in the dispute due to the existence of certain unforeseen conditions, had decided to place the CM in default and withdraw from the project.

When advised of the consequences of abandoning the project, the principal reversed course. Having followed the surety's advice to employ a consultant to assist with its defense during completion, the principal successfully completed the project, defended the suit filed by the CM, and obtained full recovery. The surety had no further involvement in the project or litigation. ■

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Subcontractor Bonding Success Stories from the General Contractor's Perspective

By Bill Waters

We all know that construction is a risky business and the economic costs of those risks were never more evident than during the recent recession and the sluggish recovery we now are experiencing. One clear indicator of that reality is increased loss activity in the surety industry. Industry losses have grown from $189 million in 2008 to nearly $1.1 billion in 2012.

We are far from being out of the woods yet, despite the recent growth in construction spending. Margins have been slow to rebound and many areas of the country still are struggling to recover.

Contractors must look for every option available to them to protect their balance sheets. It's been said that a construction project is only as successful as its weakest subcontractor. Today's margins for general contractors are too thin to absorb the costs of subcontractor default without severely impacting a project's overall profitability.

Subcontractor bonding is the foundation that many successful general contractors have built their risk management practices upon. While other risk mitigation strategies exist, they typically rely on general contractors performing their own subcontractor prequalification or employing third parties that have no financial skin in the game for their prequalification services.

Russ Gregory, CFO of the Ruhlin Companies in Ohio, summarized the situation this way, "We rely on the surety industry to prequalify its clients for the financial ability to handle our projects. We realize that an annual financial statement, even an audit, may not adequately portray the condition of a subcontractor at the time of our bid. By requiring our subcontractors to be bonded, we are receiving bids from qualified firms that have communication and financial reporting with their sureties on an ongoing basis. This provides comfort to us that we have capable contractors for our projects".

The general contractors we talked to for this article outlined a variety of strategies as the basis for their subcontractor bonding policies. They ranged from specific dollar thresholds for sub bonds (some as low as $50,000) to requiring bonds from selected critical path subcontractors. Other risk factors identified for requiring sub bonds were projects with tight completion schedules, high liquidated damages, subs performing work on the building envelope, and any subcontractors that were not well known to the general.

Ron Davoli, president of Wharton-Smith in Florida, has seen the benefits of sub bonding numerous times in recent years, not only in performance and payment situations but also in latent defect claims. Wharton-Smith bonds all subs over $50,000 and only accepts bonds from sureties with an A.M. Best Rating of A- or higher. According to Mr. Davoli, one thing they have witnessed first-hand is that a subcontractor struggling to stay afloat will give its utmost attention to completing a bonded job while even abandoning other unbonded work.

Wharton Smith's experiences with surety companies on claims have been positive. The company recognizes that it can take time for the surety to wrap its arms around the issues but felt that the sureties have been responsive and honored claims. Mr. Davoli went on to say that good, detailed documentation will produce the best results in the claims process.

Steve Stephens, president of Landmark Builders in North Carolina, is another general contractor that has a strong commitment to subcontractor bonding. According to Mr. Stephens, "We have required hundreds of subcontracts to be supported by performance and payment bonds over the last few years, and to my knowledge we have had to make claims only three times, all of which compensated us for our expenses."

Landmark experienced a problem when its bonded HVAC subcontractor did not install a required component in the air handling units and the issue was not brought to Landmark's attention until five years after the project was completed. During that period of time the subcontractor had sold the assets of its business, but Landmark was able to make a claim against the performance bond. The claim was successful and saved Landmark several thousand dollars as well as its credibility with a good customer.

David Boland of David Boland, Inc. in Florida has a policy of bonding back any subs over $50,000 plus any specialty equipment suppliers. They have reaped the benefits of several subcontractor bonds over the years when a subcontractor defaulted and the surety stepped in and tendered a replacement sub with no financial impact to Mr. Boland's company.

Mr. Boland could not recall a single incident when problems surfaced with a subcontractor and the surety did not respond in the manner expected. David Boland Inc.'s sub bonding policy was formulated many years ago after the company had to absorb a financial hit from a non-performing subcontractor. David Boland Inc. says the bond premium is well worth the cost for the added protection that it affords his company.

The surety industry's losses on many key subcontracting trades are on the rise, and many industry insiders think the worst is yet to come. The protections that subcontractor bonding affords the general contractor are more important now then ever. No other subcontractor risk mitigation tool has stood the test of time the way surety bonds have, and the surety prequalification process is a proven way to ensure a successful construction project for the general contractor and the owner. ■

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Construction Opportunities in Latin America–Understanding the Risk and the Role of Surety

By Dekker Buckley

The 2014 FIFA World Cup and 2016 Olympics will bring more to Latin America than wild-eyed fans and sports tourists. Both events are also drawing attention to the vast opportunities in the region's construction market.

Though these two high profile events will understandably spur growth in the surety and construction markets, the real growth will be fueled, more significantly, by the expanding needs in infrastructure development. These undeveloped needs, of course, represent a tremendous opportunity for U.S. contractors, but they also carry an important caveat: Business practices in Latin America's construction industry—including, but not limited to, contractual obligations, labor requirements, and surety bond coverage—can differ markedly from those in the U.S. The contractor who is adequately prepared for those differences is likely to have a significant edge over the competition.

Fuel for the Boom

While populations in Latin America continue to grow, infrastructure development in the area lags behind that of other industrialized and developing nations. In 2010, for instance, investment in Latin American infrastructure was roughly 3 percent of GDP, while investment in infrastructure in Asia was as high as 9 percent. When these two trends are factored together, the end product is likely to be a pressing need for construction and investment in areas like transportation, telecommunications, and energy production, in both the public and private sectors. And that, in turn, may well expand the growing surety bond market from an economic niche to a powerhouse rivaling, or possibly even surpassing, the U.S. market by 2019.

In fact, three of the region's strongest economies are planning or already instituting major infrastructure projects. In 2012, Brazil announced the second phase of a multi-billion-dollar public-private partnership (P3) to invest in sanitation, transportation, energy, and other sectors. (The country's overheated economy stalled last year, but most analysts expect it to recover in the long term.) In Colombia, another P3 is likely to pump billions of dollars into the economy in the form of new road construction. And in 2013, Mexico launched a five-year program to vastly expand the country's transportation and communications infrastructure.

Navigating the Market

To take advantage of opportunities in the region, contractors need to be acutely aware of potential pitfalls.

Understand the owner's requirements. Individual owners are likely to have very specific requirements, often highly detailed, in terms of appropriate authorizations, varying contract terms and conditions, and release and acceptance of the project. It is essential that all contracts be reviewed by qualified counsel who understands the local laws, customs, and nuances in connection with contractual obligations. Payment terms and conditions, for instance, can vary from owner to owner. Some may be willing to grant advance payments—a procedure that is highly unusual in the U.S.—while others may expect the contractor to come up with its own financing. If the owner is financing the project, it can be critical to understand the payment schedule. Some owners may be willing to pay after a specific outlay of cash on the part of the contractor while other owners may set specific milestones for payments, which could squeeze cash flow if not properly managed by the contractor.

Hire a project manager who thinks local. The best managers will have an intimate knowledge of the owner's expectations and the local labor markets. The issues surrounding labor can vary widely ranging from working with unions to the availability of highly skilled labor, managing compensation and benefits such as salaries, social benefits and vacation time, and the ability to terminate workers. Managers also should know the appropriate subcontractors and suppliers and be able to determine whether subcontractors have the operational capacity and necessary capital to complete the job at hand.

Know the geography. Are subsoil conditions likely to present construction or excavation problems? Are right-of-way obligations clear? Will the work be done in an area of archeological or historical importance? If pipeline is installed or a roadway is constructed through untouched regions, the discovery of a buried city or a protected group could create a whole new set of risks. On the other hand, if all the exigencies are addressed in the contract, it helps diminish the likelihood of encountering legal or financial complications.

Consider a joint venture. Sometimes the safest way to navigate a foreign market is to get into an association—a joint venture or consortium, for instance—with a group, entity, or individual already established in that market. This "partner" should be someone well versed in the local norms who can help you effectively maximize knowledge and, perhaps even more important, minimize risk.

Understand the surety market. While most surety bonds in the U.S. are conditional, bonds in Latin America may either be conditional or on-demand whereby an owner may be able to demand payment without proof of contractor default. Also, whereas the majority of performance bonds in the U.S. are equal to 100 percent of the contract price, Latin American performance bonds tend to be "low penalty" obligations, only covering from 10 percent to 30 percent of the contract price. If a valid claim does arise, sureties and their principals may also be exposed to high interest penalties if the claim is not paid in a timely manner.

Before purchasing surety bonds in Latin America, contractors need to understand both the legal environment and the bonding laws that prevail in the

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country or countries in question. One way to access the resources to obtain that information—which can be complicated and can vary from one country to another—is through a professional surety producer. It is also essential to read the contract carefully to understand which obligations will be covered under the bond. One thing that holds true in Latin America as it does in the U.S. is that foreknowledge is often the only difference between safe and sorry. ■

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Surety Bonds Ensure Performance and Payment Protections on P3s

By Curt Grove

Public-private partnerships (P3s) have peaked construction consciousness in recent years, maturing as a process in the U.S. As the technique evolves, an important element cannot be left out of the discussion: Surety bonds are essential in the model to continue the important service of performance and payment protection.

There is little argument that the country's transit system is aging and deficient. The progressive reduction in state and federal funding and increased demand for public infrastructure improvement (namely roads and bridges) is on display across the U.S. Further, there remains a lack of political will to commit to a long-term and meaningful federal transportation bill that adds funding to the nation's Highway Trust Fund. Such a reality suggests the need to overhaul a system that has changed little in over half a century. P3s are needed to push these projects to completion and advance the nation's infrastructure upgrades.

P3s (as they relate to construction) are projects or services funded through the formal partnership of private sector companies and governmental entities. A principal driver in these schemes is the financing mechanism, a structure that allows the public sector to make a capital investment without incurring debt. Rather, the debt is carried by the private sector partner in exchange for various government contributions. This is a very different paradigm than the traditional design-bid-build process.

The P3 model is not a U.S. creation. It has been around for years in Europe and only more recently an active process in North America. But just as European traditional construction and funding support models have differed from those in the U.S., so too is the evolving P3 model in this country. The European archetype generally does not utilize surety bonds but rather letters of credit and/or parental guarantees to address performance risk, and there are no payment guarantees in such a structure.

The advantages of the P3 approach to project procurement are significant. Since there are a number of stakeholders in the process, advantages to some may increase risk to others. Some of the widespread positives that benefit participants include:

- The ability of government to deliver a project with an "off balance sheet" method of financing (no debt at the public level).
- Improved collaboration and efficiency during the project versus the traditional design-bid-build method (historically fewer projects in P3 model are delivered over budget and/or late).
- Increases in construction project opportunities.
- Typically better margins and fewer competitors for contractors.
- An alternative option of delivering projects when public funding is unavailable.
- The transparency of public-sector involvement offers oversight and risk management that exceeds most traditional construction projects.
- Provides another way of leveraging otherwise under-utilized market capital.

Clearly, the financing structure is the key to raising capital for P3s. Its primary role is to drive the project through the construction phase and into the revenue generation phase. Penalties for not delivering to this phase can be severe. There are, as you might expect, a number of risks that also accompany these opportunities. As the lines of risk responsibility are muddied, it pays for the design-build contractor to have an influential and experienced advocate, the surety, working on its behalf from the early stages of the partnering agreement negotiations. Some of the challenges faced include:

- A myriad of differing rules for P3s depending on jurisdiction. At the time of this writing, well over 30 states have passed P3 enabling legislation with differing provisions. Local jurisdictions may also influence the process.
- Substantial unreimbursed pursuit costs for the construction team, which must be taken into consideration. Typically, stipend amounts fall woefully short of these costs.
- An increasing tendency for the contractor to be brought in at the developer or concessionaire level and be exposed to financing and/or "gap" funding risk. This can also extend to other "flow-down" obligations ultimately indemnifying the public entity. These could involve significant liquidated damages, efficiency guarantees, indemnification clauses, and/or operations and maintenance (O&M) exposure, just to name a few.
- Tolling risk (if relying on that revenue model), or in the case of availability payments, the risk of public entity default (not unprecedented).
- Competing interests of multiple involved parties including government entities, equity sponsors, lenders, concessionaire, design-builder (and surety), and O&M provider.
- Very little legal precedent for dispute resolution, given the relatively recent arrival of the P3 model to the U.S.

Surety bonds play an important role in the U.S. version of the P3 framework.

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Legislation in this country requires performance and payment bonds to insure completion of most public construction contracts, and not by accident. The performance bond provides a contract completion guarantee that protects public funds. The payment bond provides payment protection for subcontractors and suppliers who are not able to lien public projects. It is important that these critical protections carry forward in any new funding environment. Even though some technical hurdles may need attention, these are easily addressed within the inter-party agreements by including the surety in the process.

Although opportunities seem to be increasing as a result of this alternative project delivery method, the risks to contractors can be profound. The importance of early surety involvement is critical not only to bring meaningful oversight to the ambiguity of risk transfer in the process, but also for performance and payment protection which has been mandated by law for public projects and an essential part of public and private construction for over a century. ■

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Website Offers Small, Emerging Contractors Priceless Convenience of Learning about Bonding At Their Own Pace and Time

By Kathy J. Mapes Hoffman

A challenge for most contractors seeking a bond for the first time is understanding the surety bonding process. Now small and emerging contractors have a new resource, www.SuretyLearn.org, to help them prepare their company documents to obtain surety credit, understand the terms of the bonds and expectations, and choose a team of professional advisors who understand their specific needs.

Joshua Etemadi, sales manager of Construction Bonds, Inc., a Division of Murray Securus in Herndon, Va., said, "I always recommend my clients/prospects visit www.SuretyLearn.org, and when we get to the point where we discuss indemnity, I am suggesting they review the indemnity PowerPoint."

"That seems to be the biggest challenge for small, emerging contractors that have no experience in bonding and don't understand why the surety asks for such a strongly worded agreement (not to mention their spouse has to sign!)," Etemadi said. "That PowerPoint helps them feel more comfortable with the process, and they hear it from someone else who doesn't have any skin in the game."

The website, developed by the National Association of Surety Bond Producers (NASBP), orients small and emerging contractors to the basics of bonding and of what is needed to achieve surety credit.

"NASBP developed www.SuretyLearn.org to provide a bonding orientation resource. Producers said they frequently encountered new emerging contracting firms, which were completely unfamiliar with bonding and did not have realistic expectations of the bonding process," said NASBP CEO Mark McCallum.

A Needed Supplement to Bond Readiness Programs

"Before SuretyLearn.org launched, bond producers did not have a standing information resource tailored to small, emerging and disadvantaged contractors," said McCallum. "They were spending a lot of time familiarizing and educating such firms about the basics of bonding; now bond producers can spend more time with these firms exploring surety markets, rather than explaining the basics." However, he noted, "The website compliments but does not replace the benefits of face-to-face bond readiness programs."

Robert Coon, vice president of surety at Scott Insurance in Greensboro, N.C., agreed. Coon has offered the website as a supplemental resource during presentations he has made to historically underutilized businesses in his area. "I was able to give these business owners the basics on a fairly high level in the class, but there's only so much you can teach in an hour and a half," Coon remarked. "So for the ones that had the desire to dive a little bit deeper, get a little bit broader understanding of surety bonds...and how to position themselves for success—that was a great outside resource that they could utilize."

"A trade show, targeted at minority and disadvantaged enterprises, was a perfect venue to recommend SuretyLearn.org because the website gives the folks that attended an opportunity to learn on an independent and objective basis about surety bonds and objective information that they could absorb at their own pace," said Coon.

Information Relevant and Easy to Understand

Coon says the site's articles address important topics. For example, one describes how contractors can take steps to avoid fraudulent bonds and verify the authenticity of bonds, while other articles describe the terms of the obligations, responsibilities, and risks contractors should understand about a bond. "SuretyLearn.org is a wonderful resource because there are so many nuances to suretyship," Coon added.

Frank Lopez, the president and CEO of the U.S. Hispanic Construction Association, said the information on the site is presented in a way that is comprehensible to those who are not surety experts, particularly the course entitled "Understanding Contract Surety Bonding: An Orientation Course for Small Contractors" ($25 registration fee).

"I find the online course to be the most comprehensive, while remaining

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simple and straight forward by outlining the logical core steps that small business owners must follow to secure contract surety bonding," said Lopez. Completing the course is "critically important to the growth of any small business seeking to evolve and grow its capacity to compete in the construction industry," Lopez added.

Also, on the site, PowerPoints briefly describe how contractors can qualify and select members of their surety team members: bond producer, surety company, construction-oriented CPA, small business banker, and construction/surety attorney.

Other resources at SuretyLearn.org include forms and checklists that help small and emerging contractors identify, assess, and manage risks on a specific project.

Etemadi said the "Small Business Contractor Questionnaire form on the site helps familiarize small contractors with the questions that bond producers and sureties will be asking of them if they choose to obtain surety credit."

"While these firms have the character, capacity, and capital to be bonded, by nature, they're not at the same level of sophistication that some of the more established contractors with bonding capacity are," said Etemadi. "Two NASBP Committees created the form to help these small contractors present their case and tackle this form, which is usually the first form they're given after they contact a bond producer."

Others See Site's Resources Furthering Local, State Goals

Patrick Pribyl, senior vice president of Lockton Companies, LLC., in Kansas City, Mo., said that the website can be a resource also for public officials. "The industry is seeing more municipalities that want to provide more work for minority contractors as they get more funds for infrastructure projects," said Pribyl. "The website is a great platform to try to accomplish that."

Howard Hayes, Director of Minority Business Development for the St. Louis Development Corporation (SLDC), said, "In my professional opinion, I would strongly encourage emerging contractors to review the site."

Hayes is familiar with the needs of small and emerging contractors through his work at the SLDC that assists minority and women-owned enterprises with access to contracts and capital. The SLDC, the economic development arm for the city of St. Louis, certifies about 700 contractors from 13 counties in Missouri. Each year Hayes meets face-to-face with more than 100 small and emerging contractors.

Hayes said that the website's components meet the demanding needs of these contractors whose world is one where "time is money." "The website is a marvelous tool for them because they can learn at their leisure—that is the way to reach the 21st-century contractor," Hayes remarked. ■

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Sureties Remedy Contractor Defaults by Thinking Outside the Box

By Kevin Lybeck

The economic conditions over the last several years have taken a toll on the construction industry. Thus, it is more important than ever for owners and contractors to mitigate the risk of contractor or subcontractor defaults.

Surety bonds serve as a strong risk management tool in two ways. First, through the underwriting process, the surety invests a great deal of time and resources into determining whether a contractor is qualified to do the work before issuing the bonds, lessening the likelihood of default. Second, if the contractor does default, the surety bond, backed by the financial strength of the surety, is available to complete the project.

Unfortunately, contractor defaults do occur. When a contractor defaults, a surety typically has four options available: (1) take over the project and hire a contractor to complete the remaining work; (2) tender a new contractor to the obligee along with a payment to cover the shortfall between the remaining contract balance and the contractor's bid to perform the work; (3) finance the principal; or (4) allow the obligee to complete and pay its damages. When a principal with a large bonded backlog of work defaults, finding the best result for all parties involved requires creativity and deep claim expertise from the surety.

There are many instances where a surety has stepped in when its contractor is in trouble and obtained a favorable outcome. In a recent example, the contractor advised the surety that it had identified "valuation impacts" which resulted in the contractor's restating its financial statement. The restated financial statement reflected that the contractor was no longer financially viable. At that time, the contractor had a significant backlog of bonded work, mostly with the federal government.

The surety entered into an agreement with the contractor to provide temporary financing while it conducted its investigation. The surety assembled a team of engineers, accountants, and lawyers, and the investigation revealed that the project management teams were capable, the quality of the work was good, and that the bonded projects would remain on schedule if the subcontractors were paid. The investigation also revealed that the contractor's project management system and records were current and that the contractor owed a significant amount of money to its project vendors. Lastly, the surety learned that the contractor owed its bank a significant amount of money and that the bank had a perfected security interest in all of the contractor's assets.

In light of the surprise "valuation impact" revelation, it was clear that the contractor could benefit from the advice of a restructuring firm, which could enhance the contractor's senior management team, and at the same time, help develop a plan to get the most out of the assets that remained. Fortunately, the contractor agreed to retain a restructuring firm, which immediately began to restructure the contractor to reduce its overhead and to do the necessary due diligence required to market the assets of the contractor for sale. At the surety's request, the bonded contract proceeds were deposited into a trust account to ensure that the funds were used to pay project obligations and agreed-upon overhead. Additionally, the surety deposited money into this trust account to pay subcontractors and suppliers on the bonded projects to ensure that the work would continue while the contractor sought to sell its assets.

The biggest challenge the contractor faced in selling its assets was its secured lender who threatened to seize its collateral and file suit to enjoin the sale. Fortunately, the surety was able to negotiate an agreement to purchase the bank's position, which included an assignment of the bank's secured position in the contractor's assets. As a result, the contractor was then in a position to sell its assets free of encumbrances.

The restructuring firm advertised a request for proposals to purchase the contractor's assets and received proposals from several potential purchasers. Thereafter, the restructuring firm selected the three best proposals and requested offers from them, with the acceptance of any offer being contingent upon the contractor and the purchaser entering into an asset purchase agreement within a specified timeframe. Ultimately, the assets were sold to a qualified purchaser. The contractor, the purchaser, and the government entered into novation agreements to transfer the 17 large bonded projects to the purchaser, the vast majority of the subcontracts were assigned to the purchaser, and all 17 projects now have been completed.

By proceeding in this manner, everyone benefited. The government benefited because the work on its 17 projects continued without interruption. The project subcontractors and suppliers benefited because they were timely paid and retained by the purchaser to complete their work on the projects. The purchaser benefited by acquiring profitable government work and key personnel who had good relationships with the government. The contractor benefited because it was able to reduce its loss by selling the 17 projects to one bidder (it is more economical to look across all of the uncompleted projects when negotiating a price versus rebidding each project). Also, most of the employees of the contractor benefited because they were hired by the purchaser. Lastly, the surety benefited, as it was able to mitigate its loss because the parties chose to work cooperatively with each other to address the problem. Some of these beneficiaries may not even realize the role that bonds played in the successful completion of these projects.

At Travelers, we want to do everything we can to help our customers succeed. When a contractor does default, we attempt to work cooperatively with all parties involved to minimize losses. Sometimes, the best result can be achieved only by thinking outside the box. ■

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How The Surety Prequalification Process Aids General Contractors

By Robert Staples

Construction is a risky business. Subcontractors often are vital to project completion and as such, unqualified subcontractors can have a major impact on the project. Prequalifying and bonding subcontractors is an effective tool for shifting the risk of subcontractor failure to a surety company, and surety prequalification can help avoid subcontractor default altogether.

No matter how large a subcontractor or how long it has been in business, the possibility of failure persists. Each phase of a project requires several independent parties working together to insure success. Three basic factors lead to subcontractor failure:

Management:

- Inadequate accounting, financial, and project management systems
- Changes in ownership, management, personnel, or business strategy
- Rapid over-expansion, in volume or expansion into new geographies
- Poor owner, prime contractor, or project selection

Labor & material problems:

- Labor and/or materials shortages
- Unrecoverable cost escalations

Uncontrollable factors:

- Owner or prime contractor on another job fails to pay
- Weather problems, economic downturn, or changes in job site conditions
- Death, illness, or departure of a key employee

What Is The Surety Prequalification Process?

Surety prequalification is a rigorous, professional process by which the surety assesses the subcontractor and supports its judgment by issuing performance and payment bonds. Performance bonds assure the subcontractor is qualified to perform the work and protect the general contractor (GC) from financial risk should the subcontractor default. Payment bonds assure that specified laborers and suppliers associated with the project will be paid.

While the primary benefit of the surety's prequalification is transferring subcontractor default risk to the surety company, it is important to note that surety bonds are not traditional insurance products. Unlike alternative insurance products, such as subcontractor default insurance, surety bonds provide the GC with complete transfer of project default, not simply a cash payment that leaves issues of subcontractor replacement and supplier payment in the hands of the GC.

What Are The Benefits Of Prequalified Subcontractors?

Beyond having surety professionals involved with the overall process of successful contract completion, there are other benefits to prequalified and bonded subcontractors:

- Increased assurance of having subcontractors complete their subcontracts on time and within budget.
- A shield from paying twice for the same work items if the subcontractor fails to pay subcontractors and suppliers.
- GCs with established subcontractor bonding programs are generally viewed more favorably by their own surety company.
- Most surety companies require both corporate and personal indemnity from the subcontractors they bond. If a subcontractor becomes financially troubled, it is more likely the subcontractor will complete its bonded jobs because business and personal assets are on the line.

Other Benefits Of Surety Bonds For Subcontractors

Most sureties monitor the subcontractor's progress by routinely sending job status inquiries to the prime contractor. Although it may seem like unnecessary paperwork, it can be an effective means of communication with a subcontractor's surety.

Generally, the responses to these inquiries report satisfactory performance; however, in situations where performance or payment issues have arisen, responses can serve as early warnings of problems. When a surety is aware of a problem early, it may be able to help the subcontractor and assist with mitigation to prevent the problem from becoming a disaster.

In this way, the job status inquiry gives the GC a reasonable means of communicating with a subcontractor's surety. The GC has a right, and in some cases, a duty, to communicate with the surety about unsatisfactory performance of the subcontractor, and this communication should be initiated at any point when serious project performance problems with the subcontractor surface.

If a default occurs, the prime contractor must notify the surety in writing. The surety must acknowledge the claim, investigate the claim, and then determine and fulfill its obligations. Prior to events leading to a declaration of default, the prime contractor should have communicated the developing problems to the subcontractor's surety in an effort to resolve the issues or correct the deficiencies in performance.

Final Thoughts

There are many surety companies in the marketplace, and GCs should investigate the quality of a subcontractor's surety. Several sources rate insurance companies including: A.M. Best, Standard & Poor's, Moody's, Fitch Ratings, and Weiss Ratings. An additional resource is the U.S. Department of Treasury's T-List. The GC's surety agent also can be an excellent source on how to mitigate subcontractor risk.

With the many resources available to the GC and with the primary emphasis on subcontractor prequalification through a reputable surety, subcontractor default mitigation becomes a very manageable process, which greatly enhances the chances for successful project completion. ■

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SFAA & U.S. DOT Programs Link Bonding Education to Job Opportunities for Emerging Contractors

By Joanne Brooks and Stephanie Robichaux

The need for strong small and emerging contractors has never been more acute. Government requirements are increasing, jobs are getting larger, and small and emerging contractors have felt the force of the difficult economy more than most. Both public owners and general contractors want strong contractors on their jobs, and also want the protection of surety bonds.

The landscape is shifting. Bonding no longer is part of the conversation solely because it is mandated on public works projects but because procuring entities and other stakeholders not only want the financial protection of bonds, but also recognize that they have better participation on projects when bonding is in place. These stakeholders have become increasingly interested in bonding education programs to ensure that they have the most qualified and sustainable contractors working on their projects. Through its Model Contractor Development Program (MCDP)® and the Bonding Education Program (BEP)—the U.S. Department of Transportation's (DOT) version of MCDP®—The Surety & Fidelity Association of America (SFAA) has been assisting small and emerging contractors with becoming bondable and building sustainable businesses for many years. As the construction environment shifts, these programs continue to evolve and innovate, allowing SFAA to build local partnerships and impact more contractors.

SFAA's MCDP® was developed to give small, emerging, and minority contractors the educational and practical tools necessary to empower them to become bondable, successful business owners. What differentiates the MCDP® and BEP from other bonding programs is the direct support and participation of the surety industry.

Small, emerging and minority contractors work one-on-one with surety professionals as part of the program to learn what they need to know to run sustainable businesses, develop a trust-based relationship with a licensed surety, become bondable, and have the ability to bid on projects they otherwise would not. The MCDP® and BEP expose participating contractors to surety experts—lawyers, accountants, underwriters, producers—to whom they otherwise would not have access, which is a unique component of SFAA's bonding education opportunities.

Hundreds of small and emerging contractors have participated in and been impacted by these programs. Over half a billion dollars in bonding has been offered or underwritten as a result of the MCDP® and BEP, which has grown from three pilot programs in 2010 to 58 programs to date. Over the last year the BEP, in advancement of its goal of expanding the pool of qualified disadvantaged business enterprises (DBEs), held two BEPs completely in Spanish.

As construction procurement methods evolve, so have SFAA's programs, including tying bonding education to contract opportunities. Programs take time and contractors must choose whether or not to make the commitment. By combining education with underwriting assessments and face time with prime contractors and owners, the MCDP® and BEP give DBE contractors an opportunity to market their companies, win work, and achieve success.

SFAA and the U.S. DOT's Office of Small and Disadvantaged Business Utilization have been meeting with public entities and educating them and other stakeholders on how bonding can be used as an empowerment tool. This has resulted in expanded partnerships with public entities that are looking for impact and results, especially as the use of public-private partnerships (P3s) becomes more common. Denver's Regional Transit District understands that bonding is an economic empowerment tool and is working with SFAA and U.S. DOT to create sustainable contractors that can work for transportation entities.

We are finding public owners that believe what the surety industry believes, that we can impact communities with education and bonding and can build the community as we build infrastructure. One example of this is the $2.2 billion Purple Line project in Maryland. This P3 project not only will serve the community in terms of improved transportation, but also will provide opportunity for local small, emerging, and minority contractors. Maryland Department of Transportation Secretary Jim Smith has said, "There are many different P3s throughout North America. But the Purple Line P3 project...is in keeping with Maryland philosophy and is the most economically inclusive project of its kind." Through its Economic Empowerment Program, the Maryland Transit Administration is creating a model of combining contractor development on the grassroots level with contract opportunities. SFAA has been engaged with MTA to discuss education programs and support to ensure minority participation and community engagement on this P3 project.

What also separates the MCDP® and BEP from other bonding education programs is the involvement of prime contractors. SFAA has worked with several contractors that recognize the value of these programs, including Skanska USA Civil, Dragados USA, Clark Construction,

Lane Construction, Ferrovial USA, and Fluor Construction. Also, local chapters of the Associated Builders and Contractors have been involved in BEPs nationwide. Even on P3s, such as the I-4 project in Florida, prime contractors understand the value of bonding and support these education programs.

Ultimately, contractors, procuring entities, and primes realize that bonding is a tool that supports economic empowerment, sustainability, job creation, and legacy wealth. ■

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