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Surety Market Overview

By **Kathryn Woerheide**, Communications Manager, The Surety & Fidelity Association of America

The market cycles for combined construction and surety have been steady, which leads to increased competition. As oil and gas prices continue to fall, the current climate requires diligence and continued high underwriting standards.

According to Josh Penwell, vice president of contract surety for Merchants Bonding Co., "Underwriting terms and conditions are loosening as surety competitors are aggressively attempting to grow market share. Sureties are significantly challenged to maintain underwriting discipline in this soft surety market." In addition, John Welch, president of CNA Surety, says, "While good, basic underwriting still prevails, competition on underwriting terms will likely follow given the number of new entrants into the market. The only mitigating factor will be the direction of loss results as we move forward."

Small

The surety market for small contractors is highly competitive and rich in capacity, with competitive terms and many new players. This is due, in part, to the U.S. Small Business Administration (SBA) Surety Bond Guarantee Program and its recent change to provide a higher limit of $6.5 million. In addition, fast-track programs—those underwritten based upon credit scores up to $500,000 with a single job up to $50,000—are available for this market.

According to Lynne Cook, president of NASBP and senior vice president of Early, Cassidy & Shilling Inc., "Carriers may use some form of funds control, collateral or other tools, if needed, to assist an emerging contractor with establishing surety credit." Peter Quinn, head of bonding/surety for Euler Hermes Americas, adds, "The market is flush with companies ready to write bonds for qualified small companies, particularly if they have provided CPA-prepared financial information. The SBA assists contractors in securing bonds, while working with surety companies."

Middle

Much like the small market, the middle market is very competitive, with excess surety capacity. "There is ample competition and ample capacity in the small and middle markets, with new players entering the market on a fairly consistent basis," comments Welch of CNA Surety. According to Merchant's Penwell, "Capital is entering this market segment from new entrants, including reinsurance companies. Surety availability is plentiful for properly capitalized and well-managed companies. Underwriting terms and conditions are loosening as surety competitors are aggressively attempting to grow market share. Sureties are significantly challenged to maintain underwriting discipline in this soft surety market." Relationships continue to be crucial. Ross Fisher, senior vice president of The Hartford, adds, "In the middle market, good accounts have been staying with their existing sureties, even as competitors have offered favorable rates or terms."

Large

According to Gregg Lyon, second vice president and strategic officer of construction surety, bond and specialty insurance with Travelers, "Existing and new entrants continue to provide substantial capacity to both the large and mega end of the market." Jim Bly, managing director for Alliant Insurance Services Inc., adds, "Twelve of the top 25 sureties are able to provide capacity for programs over $250 million with at least four additional options from new sureties that pursue contractors in this sector." In addition, Courtney T. Walker, vice president of surety for Berkshire Hathaway Specialty Insurance, states, "Multiple markets are available, creating plenty of capacity, and sureties still seek reasonable terms and conditions."

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> **–John Welch, President, CNA Surety**

Mega

Given the high-capacity requirements, less sureties participate in the mega market. "There continues to be plenty of capacity in the mega account market, where there has also been greater focus on contract terms and new and emerging security products for newer project delivery methods, such as public-private partnerships," says Fisher of The Hartford. Michael Bond, executive vice president and head of surety for Zurich North America, adds, "This segment has seen the biggest impact of new surety capacity. Surety industry results have been strong for many years, and new entrants are seeking to gain market share. More established sureties have extended capacity to strong contractors who see the value of long-term relationships."

Contractor Failure

Surety industry experts agree that while there have been some significant contractor failures, the overall frequency for failure is down. "Contractor failure has been minimal for companies that have maintained an adequate balance sheet during the recession and then developed and executed a strategic growth plan as the availability of work has increased," says Penwell with Merchants. However, Bly from Alliant says there has been an "uptick in failures particularly with subcontractors. The highest risk subcontractors include framing, interior drywall, and curtainwall, electric and steel fabricators."

Walker of Berkshire Hathaway says, "Acquisitions in the market have helped spread the risk and prevent the failure of some contractors that may have otherwise struggled. Profit margins have continued to improve on 2016 bid work."

Cook with Early, Cassidy & Shilling notes that smart contractors are "making a conscious decision to not take work at a low price and to wait until it reaches higher profit margins. They choose to act on their own terms."

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> **–Josh Penwell, Vice President of Contract Surety, Merchants Bonding Co.**

Value of Surety Bonds

Surety leaders strongly encourage the use of surety bonds on projects, as bonds provide sound protection for an owner and the public. "Having the protection of a surety that can take over in the event of a default to complete the project, pay subcontractors, suppliers and vendors, and serve as a balanced voice in the event of legitimate contract disputes is a smart business practice," says Fisher of The Hartford. "A bond is the only instrument available that protects an owner's project from general contractor default and subcontractor/supplier liens; protects the subcontractors/suppliers from non-payment; and protects a general contractor against wrongful default/termination. A surety bond is time tested, supported by ample judicial decisions, and is something owners and contractors can have confidence in." Furthermore, Lyon of Travelers says, "Owners get the assurance contractors have been prequalified by a professional surety company, which points to their ability to meet rigorous financial and organizational standards." Bly of Alliant adds, "Performance and payment bonds remain the gold standard for contract security in the U.S. because they provide built-in prequalification, adjudication along with ever-improving liquidity features from the leading sureties in the market."

The Use of Surety Bonds in Private Construction

According to Walker of Berkshire Hathaway, "There is an overall increase in private work, with more bonds provided in the building area." Bond of Zurich says, "The private construction marketplace has heated up, particularly in some hot markets and segments. Disruptions in the subcontractor default market have reinforced the value of the traditional surety solutions. Prequalification of subcontractors is becoming more difficult, and the use of surety bonds is seen as a viable solution." Welch of CNA Surety adds, "We have seen a greater use of subcontractor bonding as compared to the most recent past."

Looking Ahead

Surety leaders expect the surety marketplace to remain strong in 2016 and are optimistic for continued performance due to disciplined underwriting and the industry's ability to successfully manage claims as they arise. However, losses are expected to increase. Welch with CNA Surety says, "While loss ratios remain attractive in the industry, the loss trend is creeping up. We expect this trend will continue due to the aforementioned competition. Moderating the loss activity will be the relatively modest pace of construction growth in the public sector. More loss activity would be expected should competition on underwriting terms increase coupled with a greater acceleration of public spending. Significant and more rapid expansion of work programs in times of softer underwriting climates often leads to increasing loss ratios."

Bond of Zurich says that the "industry is flush with capital, and new entrants are vying for business. Losses on the contract surety side are likely to rise closer to normal historical levels for the industry, but losses will impact the small to middle market segment disproportionately. Like contractors, surety companies are facing a challenge, with many of their staff eligible for retirement in the next three to five years. Contractors should use this opportunity to make sure they are comfortable with their surety relationships and are well positioned to enjoy consistent surety capacity with trusted partners for the years to come." Quinn of Euler Hermes shares that "the surety market is in a soft underwriting cycle and has been for the past several years. This will likely continue through the remainder of 2016. With loss ratios still favorable in the industry, it will take a downturn in the market to reduce the abundant capacity in the market. Euler Hermes doesn't expect that will change." ■

Kathryn Woerheide is the communications manager at The Surety & Fidelity Association of America. She can be reached at kwoerheide@surety.org.

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Executive Viewpoints

How have subcontractor bonds assisted general contractors and owners in the changing economy?

Ross Fisher, Senior Vice President, The Hartford, and Chair, The Surety & Fidelity Association of America: The economy hit many businesses very hard and has caused many to fail. For a general contractor or owner, requiring a bond on a project provides assurance that a third party has assessed that contractor or subcontractor's current financial and operational health, and has provided its guarantee that it is qualified to perform the project. A surety bond also ensures that subcontractors and suppliers on the project receive payment even if there is a default.

C. Constantin Poindexter, MGA, Chief Underwriter, Surety One Inc.: Regardless of the state of the economy, surety performance bonding of subcontractors is a prudent strategy for mitigating a general contractor's risk of suffering the painful effects of a sub's default. Larger contractors that can easily absorb the economic loss of a failing subcontractor may choose to treat the value of the sub's work as a simple risk retention. This might make sense if the subcontract is small and the prime contractor possesses the capacity to complete the sub's work itself. Smaller general contractors will likely not have the same tolerance for retention. Independent from the completion guarantee of a performance bond, both large and small GCs benefit from a payment bond's guarantee to materials suppliers and laborers. The prime contractors enjoy an effective shift of lower-tier risk when labor and material debts are recovered directly from a subcontractor's payment bond. The prime's liability is shifted to the sub's surety.

While there may be disadvantages to requiring subcontractors to be bonded in some instances, such as increased project costs and fewer subs that will be able to qualify to bid on the work, history evidences that the advantages outweigh them. The surety's prequalification of a subcontractor is a big plus and should not be underestimated. Also, subcontractors that get in hot water are more likely to refocus resources on their bonded work as the personal indemnity required by sureties can be a potent motivator. General contractors that have delegated large, critical or complex portions of work to bonded subcontractors have largely enjoyed better and timelier completion of those portions than GCs that have gone bare.

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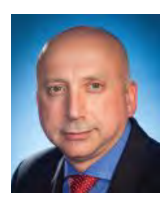
What will be the next top issue for the construction and surety industry over the next three to five years? Why?

John Welch, President, CNA Surety: While much discussed, talent will be the top issue for both the construction and surety industries over the next few years. Shortages of workers in the construction arena have been well documented in the press. Encouraging young people to enter the industry will continue to be a top priority. Charitable efforts supporting scholarships and funding of professorships will continue to play an increasing role in attracting young talent. Bringing passionate professionals into the classroom helps illuminate the endless possibilities the construction industry provides.

The surety industry is also seeing a talent shortage. Due to a shortage of training during some earlier years, the talent pool is heavier on the younger and older ends of the spectrum with a shortage of mid-career talent. As many retirements loom, the surety industry will scramble to find experienced talent to fill the gap. One way the industry is addressing this is through The Surety Foundation's internship and scholarship programs. There is good news here, as many of the younger people that have entered the industry over the past 10 years will have significant opportunities. The best attributes both industries have going for them in meeting this talent shortage is the love and passion both professions bring to their work. We will have to be our own best advocates.



Michael Bond, Executive Vice President and Head of Surety, Zurich North America: When speaking to our clients, the biggest issue they face is the attraction and retention of top talent, both on the managerial side and the trade/craft side. Many privately held contractors face continuity challenges and need to implement strategies that will transition their companies successfully into the next generation. A lack of training programs for skilled trade and craft workers in many markets makes it difficult to manage projects as the economy improves and new project opportunities are presented.

Sureties as well face talent questions, as many baby boomers in key managerial, underwriting, claim and legal positions are eligible for retirement in the next three to five years. Contractors and sureties face critical challenges in this area; those that can successfully positon themselves will be well prepared to thrive in the coming decade.

Josh R. Penwell, Vice President, Contract Surety, Merchants Bonding Co.: The surety industry is in a war for talent. A properly trained underwriter who makes well-thought-out and responsible decisions is critical for a surety company's success. Underwriters are reviewing and making decisions on multi-million-dollar surety bonds every day. The surety industry is lacking an adequate amount of quality underwriters to make these decisions.

The surety industry has experienced minimal growth during the recent recession. This should not be surprising considering the lagging construction market over the past several years. The surety industry went through an extended period of time without the need to hire and train underwriters. Now that the construction market is trending up, the surety industry is trying to play catchup. Like many industries, the surety industry has also experienced the loss of many good underwriters through retirement. In addition to this, the fact that the surety industry has many new players entering the industry and aggressively trying to grow market share has placed a significant amount of emphasis on the need for quality underwriters. The desire for well-trained underwriters in a highly competitive marketplace is real and will likely be a strain on the resources of many companies in the surety industry for the next several years.

> ***"One of the most pressing issues for the construction and surety industries is the transition of leadership from experienced professionals to new people entering the industry. Both contractor and surety folks are definitely seeing a void of talent–the age gap."***
>
> **–Lynne W. Cook, President, NASBP, and Senior Vice President, Early, Cassidy & Schilling Inc.**

Lynne W. Cook, President, NASBP, and Senior Vice President, Early, Cassidy & Schilling Inc.: One of the most pressing issues for the construction and surety industries is the transition of leadership from experienced professionals to new people entering the industry. Both contractor and surety folks are definitely seeing a void of talent—the age gap.

The transfer of knowledge to new people in the surety industry presents two challenges. First, we have to assure we have an adequate pool of people to choose from to hire. Second, we have to manage their values, expectations, communications and personalities, while ensuring a transfer of knowledge among them. The goal is to have retiring or soon-to-be retiring professionals share what they know about their clients and about the surety industry with new people in the industry. Many employers are encountering a difficult dynamic stemming from the age gap of their staff. For example, an experienced professional may hold his or her knowledge close to the vest, and a new professional may maintain a thought process of avoiding advice from others. As an industry, we have to make ourselves more attractive to new people when they are choosing a career. Some companies have tackled this by creatively appealing to the values of those in college today and by helping these students see the benefits of working in the surety and insurance industries. As an industry, we all need to help them realize that the surety industry offers inviting career opportunities.

The concern about the generation gap applies to the construction industry as well. Typically, experienced contractors and new construction managers have received very different forms of training. Most new construction managers on today's jobsites did not start in the field on a jobsite and received college training primarily on how to use construction technology with less hands-on knowledge of the construction process, while most experienced contractors were trained in the field and obtained a working knowledge of how a building is built over a period of several years. This difference in training is impacting how jobs and communications are managed among the parties on a project, which is contributing to problems at the construction site.

Courtney T. Walker, Vice President, Berkshire Hathaway Specialty Insurance: Some top issues facing the construction industry and, in turn, the surety industry are: increased technology and sophistication among contractors, differing types of construction delivery and competition for performance security (i.e., letters of credit in lieu of surety bonds). The increased use of building information modeling (BIM), green building standards, etc. are designed to build better products faster and ones that last longer. Similarly, alternative project delivery methods, such as the various types of public-private partnerships (P3s), are used not just for financial reasons but also to build longer-lasting projects with increasingly efficient designs and methods. As construction

efficiencies and time pressures increase, the challenge for the surety industry is twofold: are we equipped from an underwriting and claims perspective to handle the increased need for speed in our decision making, and are we prepared to sell the surety bond product in light of increasing competition from other forms of project security, such as letters of credit and parental guarantees? How the surety industry rises to these challenges will have an impact on the level of surety bonding in the P3 and private construction markets going forward.

What new trends do you see emerging in public construction, and why are surety bonds an important part of those construction projects?

Gregg Lyon, Second Vice President and Strategic Officer, Construction Surety, Bond & Specialty Insurance, Travelers: We are optimistic about the stabilizing public works sector. Highway and bridge construction has been steady, and we have seen modest gains in some other areas.

To be more competitive in this stabilizing environment, sureties have started providing guarantees that include commitments to a quicker formal response to a claim under a performance bond when a subcontractor is at fault.

There are some sureties, like Travelers, that are refining bond language to be more responsive to claims, and allow flexibility for a prime contractor or owner to continue a contract during the investigation process. In addition, we are providing clearer instructions on how to file a claim and who to contact.

The goal is for these enhancements to make bonds even more attractive as a performance security option.

Specifically, in the public sector, we continue to see more public-private partnerships. In these instances, surety bonds provide great risk transfer alternatives. For example, bonds may serve as a good alternative to letters of credit when surety is an accepted alternative. A key benefit of a surety bond is the knowledge that a strong team of surety claim and legal experts is available to mediate with the bond obligee to work through a dispute on a bonded obligation.

Peter Quinn, Head of Bonding/Surety, Euler Hermes Americas: The increase in P3s. Public-private partnerships (P3s) are business relationships between a private-sector company and a government agency for the purpose of completing a project that will serve the public. Public-private partnerships can be used to finance, build and operate projects. Financing a project through a public-private partnership can allow a project to move forward. With government funding restraints on construction and the inherent need to upgrade U.S. infrastructure, P3s are an avenue to get a project off the ground. There are pros and cons to the P3s. One of the negatives for the surety industry is the size of these projects, which can typically run in the hundreds of millions of dollars or larger. The mega size of these projects will only include very large contractors and will limit the number of sureties participating due to the size of the bond requirements.

James Bly, Managing Director, Alliant Insurance Services Inc.: Public-private partnerships (P3s) are gaining momentum throughout the United States as an efficient means to design, build, finance and maintain government construction projects. Under a P3 project, the government entity will generally issue an RFP to engage a concessionaire for the project. The concessionaire will secure funding for the project, while holding the right to use the project property for the duration of the construction, operations and maintenance period outlined in the agreement. The public sector retains ownership and ultimate control of the public asset in a P3. The concessionaire secures funding for the project and enters into agreements with the government agency who will provide availability payments that are based on construction and O&M milestones. These payments can be structured to meet the government's budgetary constraints, allowing projects to be delivered in a shorter timeframe, while government funding is spread over multiple years and operating budgets.

Government funding shortfalls are the most important reason for both public and private partners to pursue a P3. Public entities also believe risk transfer is an important part of the P3 model. Generally, the private sector assumes the financing, construction and operational risk, while the public sector retains ownership and sets the standards for the construction and use of the asset.

The concessionaire will generally engage a design-build contractor to complete the construction phase of the project. The security requirements for the design-build contractor are ideally structured to meet the needs of the concessionaire and its lender, as well as providing the protection for subcontractors and suppliers. Since subcontractors and suppliers are unable to perfect a lien on P3 projects, surety bonds that include a performance bond with an accelerated dispute-resolution process or liquidity feature, as well as a payment bond for the protection of the subs and suppliers, remains the security of choice for the benefit of all project participants. If letters of credit are used in lieu of surety bonds for the security for the contractor's performance, the subcontractors and suppliers to the contractor will have no recourse against the bank that issues the letter of credit, leaving the subs and suppliers exposed to the default risk of the contractor. ■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Subcontract Bonds Keep Projects on Track

By **Josh Penwell**, Vice President, Contract Underwriting, Merchants Bonding Co.

Contractor default is a train wreck with the potential to cause huge losses for everyone involved. The risk of contractor default is why surety bonds are put in place to secure the successful outcome of a project. The research shows that more than 25% of construction contractors face project defaults for many reasons, and while not all of them are foreseeable, most are due to performance, financial or resource management issues.

If a subcontractor fails, it can seriously damage the reputation of the general contractor and its ability to win future work. Properly managing the risk of subcontractor failure can be the difference between a successful project and a disaster. Here are the top 10 ways that subcontract surety bonds keep projects from "running off the rails."

1. A surety bond prequalifies the subcontractor. The most effective and cost-efficient method for an owner or general contractor to mitigate the risk of contractor and subcontractor failure is to require performance and payment bonds from a qualified surety.
2. Requiring bonds from subcontractors will not turn a bad job into a good job, but a surety bond not only prequalifies the subcontractor, it also provides assurance to the general contractor that the subcontractor will fulfill its obligations and pay material suppliers. The payment bond mitigates the exposure from second-tier subcontractors, suppliers to subcontractors, and unions.

> **The surety bond is guaranteeing your work. Surety credit from a reputable bonding company is a valuable stamp of approval that you have been vetted and found capable and reliable to keep the train running on track.**

3. Surety bonding protects and helps ensure that project owners, architects, lenders and end users will be satisfied.
4. Subcontract bonds save substantial overhead expenses in the form of lower legal fees, less management time spent on nonproductive issues, and less time spent sending unnecessary correspondence.
5. It is more cost effective to pay the small price of a bond premium to have a professional surety agent and underwriter assist you with risk mitigation than to handle it internally and pay the overhead for it.
6. By providing payment and performance bonds, the surety helps to evaluate the risks associated with various contractors, and helps determine the appropriate levels of project sizes and programs that a contractor should undertake.
7. Subcontractors are motivated to fulfil their obligations on their bonded projects since the owners of the company typically provide their personal indemnity to the surety. A troubled subcontractor is more likely to complete its bonded jobs since personal assets are often at stake. This factor may possibly provide the prime contractor with the leverage to keep the subcontractor performing on the job.
8. Working closely with your surety bond agent and underwriter when trouble starts may help the subcontractor avoid default.

> **The surety can be your best friend in finding creative solutions when a default cannot be avoided. Surety saves the project but also the contractor's reputation.**

9. The surety can be your best friend in finding creative solutions when a default cannot be avoided. Surety saves the project but also the contractor's reputation.
10. A sophisticated general contractor should have a formal subcontractor bonding policy in place that clearly determines when bonds should be required from subcontractors.

Sureties can often save a project if it is bonded properly. So project owners and contractors both have an interest in making sure that contract surety bonds back their project.

For the subcontractor, your surety will often provide support and assistance in the event of financial, performance or resource management difficulties. The surety bond is guaranteeing your work. Surety credit from a reputable bonding company is a valuable stamp of approval that you have been vetted and found capable and reliable to keep the train running on track. ■

Cybersecurity: How Prepared Are You?

By **Tim Francis**, Enterprise Cyber Lead, Travelers

For construction companies to thrive, it's essential to stay nimble, adapt and keep up with technology. Technology is driving a seemingly daily change in the workplace with the rise of mobile business devices and apps, and opportunities the cloud offers for data storage and collaboration.

But, when technology is the most rapidly evolving component of any business today, risk can accumulate, leaving a business vulnerable and even decimated. As a recent Symantec report shows, small to mid-sized businesses are the prime target, with 59% of all cybercrime directed at them.

Most at Risk, Least Prepared

Small businesses are certainly attuned to the risk. In Travelers second annual Business Risk Index, cyber risks are among the top concerns for business owners, second only to medical cost inflation. Forty-five percent rank cyber risk as a major threat. But that number is less than the reported worry of large businesses (70%) and mid-sized businesses (60%), according to the Travelers survey.

And, Travelers found that the worry does not match the action, as 29% of small businesses say that they are less prepared to face cyber threats than any other risk, and only 33% have a cyber or data breach plan in place.

Keeping Up With the Cybersecurity Trend

Seeing that small businesses are most prone to cyberattacks yet the least prepared, what steps can provide better protection and security?

Travelers recommends essential actions that every business should consider:

- Protecting secure customer information
- Reviewing vendor vulnerabilities
- Requiring employees to use more secure, complicated passwords, and to change them on a regular basis
- Monitoring use of mobile devices and public Wi-Fi access, and establishing usage standards

Make sure that all employees—full time, part time, permanent, temporary and interns—understand security policies and have signed affidavits to that end.

Having an incident response team in place is also essential even if a business has never experienced a cyberattack. Knowing who in an organization is responsible for specific actions—notifying the insurance provider, securing data, etc.—is key to responding to an attack quickly and effectively.

The best incident response teams are composed of leaders from a variety of departments—IT, C-suite, HR, PR, legal, operations—to manage all aspects of a breach, from employee investigation to customer communication.

Solid response plans include the following actions:

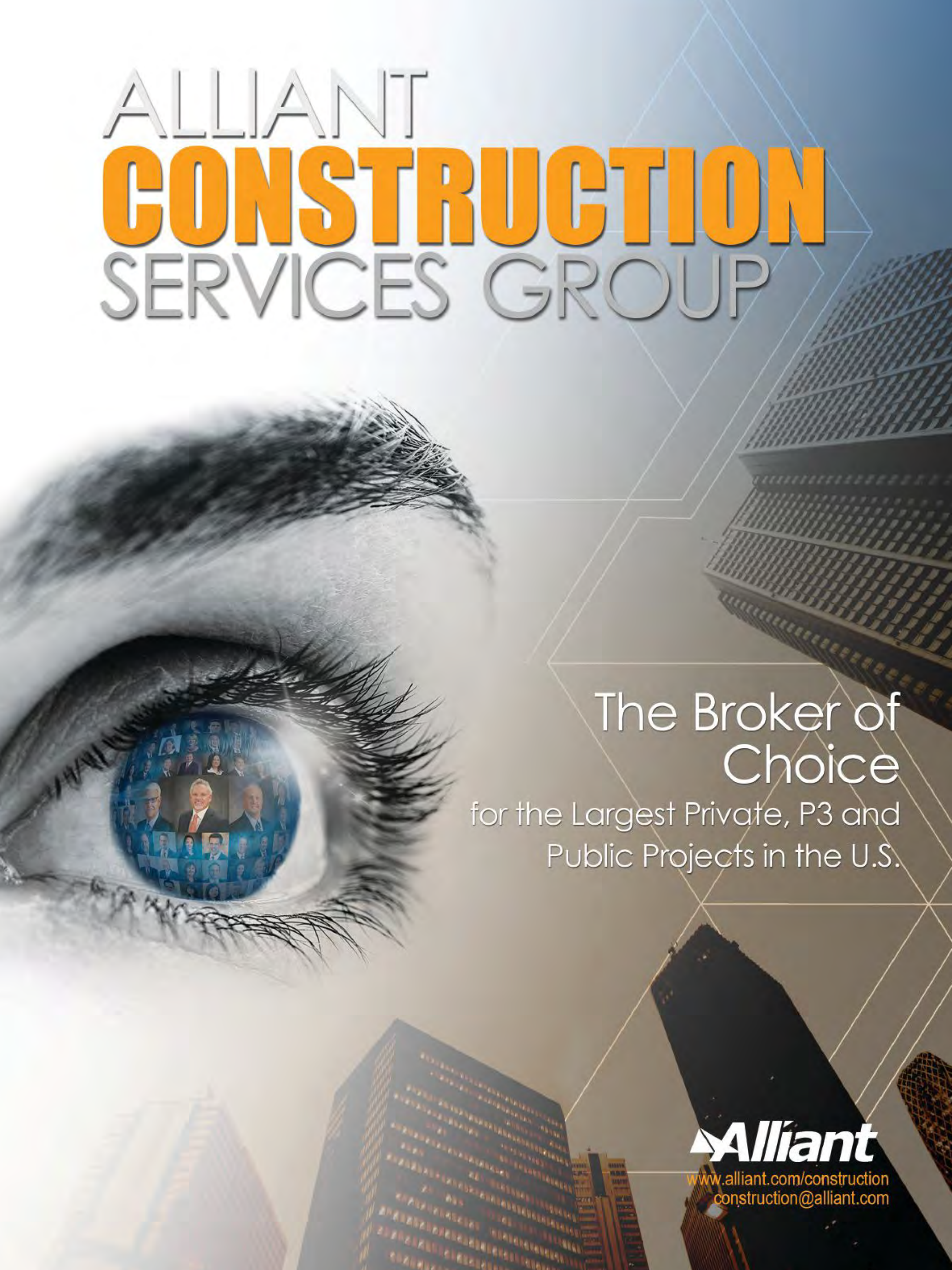
- Notifying your agent and insurance carrier as soon as possible
- Classifying the data breached to understand what type of information was compromised
- Contacting law enforcement if necessary
- Assessing the scope
- Determining whether forensic investigation is needed
- Securing the data
- Developing a communications plan
- Testing the system

Finally, work with an independent insurance agent to make sure there is an understanding about what vulnerabilities are covered and that there are policies in place to limit cyber risks. In the Business Risk Index, only 7% of construction companies buy separate coverage for cyber risks, while 44% feel they are already covered for cyber risks by other insurance.

Cyber risks shouldn't be underestimated as our lives and businesses become increasingly connected to technology. Working closely with an insurance agent as well as an attorney who is experienced in small-business matters can go a long way toward building an advisory team that can be there in times of trouble–and also beforehand, in a preventive capacity.

When it comes to cyber risk, small businesses simply can't afford to let their guard down. According to a 2015 study by The Ponemon Institute, the average cost of a data breach was $217 per compromised customer record, up 8% over the prior year.

That said, cyber risks shouldn't be underestimated as our lives and businesses become increasingly connected to technology. Working closely with an insurance agent as well as an attorney who is experienced in small-business matters can go a long way toward building an advisory team that can be there in times of trouble—and beforehand, in a preventive capacity. ■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P3 Considerations from the Subcontractor's Perspective

By **Rosemary Quinn**, Vice President and General Counsel, CNA Surety

The growth of public-private partnership (P3) projects in the United States and Canada has generated much discussion that focuses on the changing roles and obligations of lenders, developers/concessionaires and contractors. However, the impact on subcontractors should not be overlooked or underestimated. The most important first step for subcontractors is to obtain a copy of all agreements that are associated with the P3 project and not limit their document review to the subcontract. The goal of the subcontractor and its advisors should be to: (1) confirm and protect the subcontractor's payment rights and (2) avoid any direct or indirect assumption of the financing obligations associated with the P3 project.

Challenges to Securing the Subcontractor's Payment Rights

Surety payment bond. The best payment protection for a subcontractor is a surety bond. It is the only security available that grants the subcontractor a direct right of action to enforce payment owed by the prime contractor or others. However, payment bond concepts that are commonplace on non-P3 projects may not always exist on P3 projects. First, it is recommended that subcontractors confirm that the governing law requires surety payment bond protection for P3 projects. If the law does not require payment bonds, then the subcontract should be reviewed to confirm that there is a contractual requirement to provide surety payment bonds for the subcontractor's protection.

Second, determine the amount of any required surety payment bond. Even if a payment bond may be required by law or contract, the bond will not necessarily be 100% of the contract price.

Letters of credit or other bank instruments. If the prime contractor offers a bank product in lieu of a surety payment bond, it should be assumed that the subcontractor will not have a direct right of action against the issuer of such bank product. Further, it is likely that the amount of such alternative payment security will be less than 100% of the value of all payment obligations on the P3 project.

Right to stop work. Confirm that the subcontract does not limit or condition the right to stop work in the event of nonpayment. The subcontractor should not assume the risk of nonpayment if there is a gap in available financing or the financing facility defaults on its financing obligations to the developer/concessionaire. The subcontractor's payment rights should also not be diluted in the subcontract by pay-if-paid contract clauses or waivers of prompt payment law protections.

Mechanic's lien rights. Subcontractors should assume that such lien rights do not exist on a P3 project. Even though the source of funding is private, the property to which the lien would attach is public. There have been exceptions to this general rule, but such cases concerned a lien on a developer's leasehold interest in a public project and not the public property. Assume that the subcontractor will not have a right to lien in the event of nonpayment.

Prompt payment acts. Although prompt payment laws exist in most states, it is advisable to determine whether such laws apply to P3 projects in the state where the work is performed. Since many prompt payment laws distinguish between public and private work, the P3 project may be treated as private work for purposes of the protections afforded by the applicable prompt payment law.

How to Avoid Assumption of P3 Financing Obligations

Subcontract. Many or most subcontracts include an "incorporate by reference" clause so that the subcontractor is obligated to the prime contractor for all liabilities and obligations that are owed by the prime contractor to the developer. This is not unusual, and most subcontractors expect such clauses in their subcontracts. However, the P3 environment requires closer examination in order to avoid the unintended assumption of financing risks that the prime contractor may have. In a perfect world, the subcontractor should be provided copies of all agreements, including financing documents, and will have the appropriate staff and time to evaluate all such documents. Although the benefit of such a complete review cannot be overstated, this is often not feasible. One suggestion is to include, in subcontracts and subcontractor provided surety bonds, language that excludes the subcontractor from all liability that may arise from any of the financing-related obligations that concern the P3 project.

Subcontractor's security obligations. Subcontractors may be required to post surety bonds or other forms of collateral to secure their performance and payment obligations under the Subcontract. It is recommended that subcontractors determine the amount and form of all such collateral early in the process in order to provide the subcontractor and its surety adequate time to evaluate the security requirement. ■

Rosemary Quinn is vice president and general counsel of CNA Surety. She can be reached at rosemary.quinn@cnasurety.com

Surety and the Energy and Mineral Industry

By **Robert J. Duke**, General Counsel, The Surety & Fidelity Association of America

One of the hottest topics in the news right now is the financial condition of certain coal mining companies. It is critical that funds are available to reclaim the mined land. The surety industry provides bonds to all areas of the energy and mineral sector. Coal mine operators must furnish security to obtain state mining permits. In the vast majority of instances, that security is a surety bond. The bonds generally secure the obligation that the operator will reclaim the land at the completion of the mining operations.

In certain states, a financially strong operator may be allowed to provide a guarantee securing its reclamation obligations in lieu of a bond (i.e., self-bond). The authority to regulate coal mining operations has been delegated by the United States Dept. of Interior (DOI) to the states under the federal Surface Mining Conservation and Reclamation Act. Hard rock miners of non-coal minerals must furnish bonds to state regulatory agencies also securing their reclamation obligations. Lessees of oil wells must furnish bonds to the DOI's Bureau of Ocean Energy Management (BOEM) to guarantee that the wells will be capped and plugged at the conclusion of drilling operations.

Given the regulatory context, changes in the regulations affect the operators' risk and the sureties' risk. Currently, the energy and mineral industry is facing regulatory pressures that ultimately may affect the surety and energy and mining industries. There are recent news reports regarding mining operators deteriorating financially and losing the ability to self-bond their reclamation permits in the billions of dollars. BOEM is revising its supplemental bonding policy to eliminate the broad practice of waiving supplemental bonding for wells that are leased by major operators with significant assets so the supplemental bond requirement now will apply to more lessees and operators, particularly in the Gulf of Mexico. Lastly, the Environmental Protection Agency (EPA) is seeking to require hard rock mining companies to furnish financial assurance under section 108 of Superfund.

At the Annual Meeting of The Surety & Fidelity Association of America (SFAA) on May 5, SFAA hosted a panel discussion consisting of officials from the DOI and the EPA. Officials provided a picture of the "state of play" in the energy and mineral industries, particularly the regulatory and economic pressures that are effecting these industries, for which sureties provide reclamation and plugging bonds and general financial assurance. On the panel discussing these pressures were: Barnes Johnson, director of the Office of Resource Conservation and Recovery, EPA; Brandi Colander, deputy assistant secretary, Land and Minerals Management, DOI; and Joseph Pizarchik, director, Office of Surface Mining Reclamation and Enforcement, DOI. William Gorton, a partner from the law firm of Stites & Harbison, moderated the panel.

Pizarchik discussed the deterioration of several major coal-mining operators and their failure to maintain eligibility to use self-bonds as a reclamation assurance for coal mines. Self-bonds are legally binding corporate promises without separate surety or collateral, available only to permittees who meet certain financial tests.

Pizarchik stated that in light of the aforementioned events, the position of the Office of Surface Mining Reclamation and Enforcement is that state regulatory agencies should exercise their legal authority and not accept new self-bonds. He anticipated the publication in the Federal Register a notice seeking public comment on a petition for rulemaking that seeks a regulatory change that would limit the option to self-bond.

Colander discussed the new policy by the BOEM to expand its supplemental bonding policy. Under the new policy, more lessees and operators in connection with wells in the Gulf of Mexico will be required to furnish a bond to cover the decommissioning liability. Colander stated that in light of depressed oil prices, BOEM has a strong commitment to risk management to ensure that decommission costs are covered when a well operation is completed. She stated that the new policy will be released as a notice to lessees in the summer. Implementation of the new policy will be on a case by case basis that is tailored to the specific risk.

Johnson explained that section 108(b) of Superfund calls for developing requirements that facilities furnish financial assurance. EPA is considering requiring coverage for: the costs of response in the event there is a release or threat of a release of hazardous substances; health assessment costs; and natural resource damages. A surety bond is one of the forms of assurance that is under consideration. In 2009, EPA identified the hard rock mining industry as the first for development of section 108(b) requirements. EPA currently is working on the regulations to implement section 108(b). Johnson anticipated the proposed regulation to be completed by Dec. 1, 2016.

SFAA will be monitoring these developments as they progress, and will be advocating for reasonable and meaningful bond requirements for which there is available capacity. ■

A Security Comparison: Parent Company Guarantees vs. Surety Bonds

By **Courtney T. Walker**, Vice President, Surety, Berkshire Hathaway

The United States construction market and its various stakeholders have long been aware of the benefits of surety bonds as performance and payment security for the obligee/owner, the general contractor/oblige, and subcontractor and supplier claimants in the event that the contractor breaches the construction contract, or upon the contractor's insolvency. In the past few years, however, we have seen an increase in an owner's demand for parent guarantees either as a supplement to bonds (belt and suspenders, if you will) or as a substitute of bonds or letters of credit.

By definition, a parent company guarantee (PCG) is a conditional promise by a parent company to answer to a third party (obligee) for the debt or default of its subsidiary. It is a secondary obligation that is contingent on the subsidiary's primary obligation under the underlying contract, coextensive with the liability of its subsidiary. At first blush, the appeal of a parent guarantee in lieu of surety bonds is understandable. There is no bond premium, although some parents charge a fee for the guarantee, hence the obligee's cost is reduced, and depending on the language of the parent guarantee, the obligee's protection may be broader and of greater duration. Also, the PCG given to an obligee typically does not contain a financial limit on damages. However, other than these distinctions, the differences favor the use of surety bonds.

In the event of a surety claim, the surety has a responsibility to independently investigate the claim. While the principal's defenses are available to the surety, the parties can expect the surety to act in good faith in its response to an obligee and claimants. Under the PCG, the defenses of the subsidiary (bond principal) are likewise available to the parent. However, the parent of the defaulted affiliate or subsidiary in a contested default may not have the same independent response or obligations of good faith in its review and investigation, thus potentially diminishing the obligee's security for performance.

Surety bonds provide protection that the construction contract will be completed in the event of contractor default and contractor insolvency.

Using a PCG in place of a bond also raises some practical concerns. Filing a claim under a surety bond is a process that is typically either outlined in the bond itself or a state or federal statute, but what is the path for suppliers and subcontractors to access a parental guarantee? Typically, these claimants have no direct rights against a PCG.

A larger concern of a PCG is the parent company's ability to address an insolvency issue if one arises, either with a subsidiary or with the parent itself. Using the first example, if the principal cannot pay its bills, are parental assets in place to protect the obligee and claimants? Is the parent a shell company that really has little or no assets? In order to properly assess the value of a PCG, the obligee should assess the financial strength of both the contractor and any proposed parent guarantor; whereas a surety bond can obviate the obligee's need to perform such an additional assessment by looking to the surety, which will then underwrite the account. Also, the parent company may hold sufficient assets to satisfy the guarantee obligation at the time the PCG is provided, but without specific covenants in place, such assets can then be transferred within a corporate group.

Lastly, it should be noted that if a contractor becomes insolvent, it would not be particularly unusual for a parent company to also become insolvent at the same time. There are current examples of this issue presently being addressed in U.S. bankruptcy courts. In a recent case, a large international contractor is attempting to reduce its debt by billions while restructuring remaining debt, whereas its subsidiaries have filed separate bankruptcy actions in U.S. courts. In this scenario, any obligees or beneficiaries holding a PCG as its only security may not ultimately benefit from the parent company's promise regarding the contract obligations of the bond principal.

Speaking generally, PCGs are often provided by global companies that can be impacted by economic factors outside of the U.S. construction sector (such as the economic slowdown in Asia, slower-than-expected recovery by the European banking market, the energy/oil and gas market, etc.). It follows that these factors present real risks, and if a company's balance sheet is squeezed, the value of the parent guarantee is diminished. Surety bonds provide protection that the construction contract will be completed in the event of contractor default and contractor insolvency, which may not always be the case with a PCG. Thus, while the PCG may appear to be an expense-free form of project security, it may not be a loss-free form of security.

As such, a more secure approach for obligees and claimants is to rely on the financial strength and ratings of a surety company, and the long-standing benefits of surety bond protection. For these reasons, the reliability and predictability of surety bonds is a better choice. ■


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Preserving Working Capital with Surety Bonds

By **Peter Quinn**, Head of Bonding/Surety, Euler Hermes Americas

Access to working capital has long been a critical component of a contractor's success. It not only keeps a company afloat, it can also make a huge difference in providing the necessary flexibility needed to pursue a wider variety of projects. Even at the most basic level, contractors always want to have a cushion to ensure that they can overcome a (sometimes unforeseen) bump in the road.

As a result, proper management of a contractor's liquidity is often designated as one of the company's top priorities. If managed properly, a company prospers and enjoys a competitive advantage; if restricted, a contractor's business is placed at great risk.

Cash flow issues can be compounded if a contract includes retainage—a portion of the agreed-upon contract price is deliberately withheld until the work is substantially complete to assure that contractor or subcontractor will satisfy its obligations and complete a construction project.

Options for Unlocking Liquidity

A key way that contractors can preserve liquidity is by using surety bonds. Since no tangible security is required, contractors are free to use their assets for business growth and procurement of additional working capital. This increases the chances that they will be able to complete the project, while leaving cash free for potential new projects. Bonds do not work to reduce bank lines of credit.

In addition, U.S. surety bonds provide a great deal of comfort for the contractor and the owner: performance bond for 100% of the contract value to ensure performance of the contract, and 100% payment bond that protects subcontractors and suppliers, and often a 10% maintenance bond for the first year after completion. The premium is based on 100% of the contract value while the duration lasts the length of the contract or obligation. They normally are underwritten on an unsecured basis with emphasis on indemnity agreements to cure potential claims.

A less popular alternative to surety bonds are letters of credit, which tend to be used more frequently in Europe, with far less penalty amounts. As opposed to the requirements of surety bonds, bank lines of credit, cash and other liquid assets are used or pledged as collateral to secure letters of credit, effectively reducing a contractor's working capital and tying up its borrowing ability. This can significantly hamper growth and lead to a contractor turning down projects due to cash flow issues.

Moreover, coverage might not be comprehensive with letters of credit. These arrangements provide payment demanded within limits but do not provide for contract completion. In addition, subcontractors and suppliers are not protected under letters of credits.

Creating a Partnership

Surety is a relationship-driven business, and there must be a trust developed among the broker or agent, surety and contractor. The surety will prequalify the contractor by determining whether the principal has the financial wherewithal and experience to meet the bonded obligation.

For generations, sureties have relied on the three Cs:

Capital: They want to know that the contractors they are working with have the financial resources they need to complete the project.

Capacity: A contractor must demonstrate that it is able to do the job and possesses the necessary experience and knowledge.

Character: Like in most lines of business, sureties want to deal with reputable people.

A key way that contractors can preserve liquidity is by using surety bonds. Since no tangible security is required, contractors are free to use their assets for business growth and procurement of additional working capital.

As for a contractor, it should look for a true surety partner that understands its business and business plan. The surety and the contractor should have frequent communications and share a constant stream of information so the surety can respond to the contractor's needs and ensure mutual success. With a true partnership, a contractor can ensure its working capital remains intact and its business continues profitable growth. ■

Peter Quinn is head of bonding/surety for Euler Hermes Americas, which offers investment grade ratings (AA- S&P, A+ A.M. Best), a global team of 150 specialists, personalized service, nearly 100 years of experience and more. With nearly 30 years of experience, Quinn worked at some of the leading sureties in the United States before launching Euler Hermes' offering. Learn more at www.eulerhermes.us/surety.

Surety Bonds Can Benefit Contractors in the Evolving North American P3 Project Market

By **Brent McAllister**, Director, National Accounts, Zurich Surety

The growing use of public-private partnership (P3) projects to deliver public infrastructure in Canada and the United States has produced an evolving North American approach to P3 project security. Initial North American P3 projects were modeled after foreign market approaches that incorporated low-percentage and on-demand performance security typical of construction procurement in Europe, Asia and Australia. At the same time, project finance rating methodologies focused on liquid and unconditional security came into use in Canada and the United States. This P3 approach was not aligned with North American contractor balance sheet structures, bank line sizing or ready access to large-capacity surety facilities established to meet the high-percentage performance and payment bond requirements of most public construction work in Canada and the United States.

In response, many domestic contractors were forced to negotiate increased letter of credit facilities by providing banks with enhanced security packages or leveraging government export agency support. North American contractors also partnered with surety companies to develop bond product innovations that maintained the broad coverage of high-percentage surety bonds, while meeting the time-certainty needs of P3 projects. As the North American approach to P3 project security continues to evolve, it is important to revisit the many benefits that surety bonds can provide to contractors pursuing and executing P3 projects.

Reduced Pursuit Costs

Developing P3 project proposals can take years of effort and cost contractors millions of dollars. Pursuit costs can quickly escalate when the procuring agency has not developed standardized processes or documentation. Many surety companies have been active in the North American P3 market for more than a decade and are well-equipped to help contractors minimize pursuit costs by sharing best practices and lessons learned on past project pursuits in different geographies with different procurement agencies. Early involvement by the surety can help develop document language, provide precedent P3 transaction information and avoid common challenges.

Contract Advisory and Legal Resources

Risk allocation amongst multiple project stakeholders and the complex interdependence of contractual relationships remain key challenges on all P3 projects. Contractors invest significant time and resources to negotiate the risks and project obligations passed down from the concessionaire. Sureties with P3 experience can supplement these efforts by assisting contractors with contract review services and access to legal resources. Many surety companies can also provide market standard guidance and insights around key contract language accepted by stakeholders on past projects, form and amount of comparable performance security packages or prior negotiations with project lenders, financial advisors and rating agencies.

Tailored Bond Language for P3 Project Stakeholders

The surety industry continues to develop P3 bond language that further enhances the broad coverage of high-percentage performance and payment bonds by explicitly securing payment of liquidated damages, quantifying surety response timelines, establishing expedited claims processes and incorporating funding agent and public owner step-in rights. Leading sureties have experience and demonstrated results tailoring bond language to meet the time certainty needs of P3 project concessionaires, lenders and rating agencies.

No Burdening of Bank Lines With Letters of Credit

Most contractors qualified to pursue North American P3 projects enjoy large-capacity surety facilities available to support full contract value performance and payment bonds securing multiple projects. Unlike typical letter of credit facilities, North American surety capacity is largely extended on an unsecured basis. Use of high-percentage surety bonds to secure North American P3 projects can provide contractors with a sustainable performance security option that reduces the expense of increasing bank line limits (and lender security packages) beyond a contractor's actual borrowing requirements.

Surety Remedies Beyond Funding a Demand

The role of letter of credit-issuing banks in a P3 project begins and ends with honoring a demand for payment and seeking immediate reimbursement from the contractor. High-percentage surety bonds eliminate demand risk for contractors, as the surety is required to investigate default claims in accordance with the P3 bond's claims process and response timelines. Surety companies are also motivated and equipped to help contractors avoid default on individual contracts and across a program of bonded projects. ■

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A Professional Bond Producer Is a Contractor's Essential Resource for Navigating the Intricacies Of Surety Bonding

By **Mark McCallum**, CEO, NASBP

Obtaining surety credit starts with a professional surety bond producer. Arranging bonds and a line of credit with a surety company requires extensive, detailed work for every bid submitted. Not every agent or producer can navigate this process seamlessly or successfully for those firms interested in establishing surety credit.

Each surety company has its own unique underwriting standards and practices, and the prequalification process can be a challenging experience if not handled by a surety bond specialist. A professional bond producer—one who focuses his or her career on surety bonding relationships—can serve as an objective, external resource for evaluating a firm's capabilities and, where necessary, can suggest improvements to help a firm meet a surety company's underwriting requirements.

An Ongoing Relationship

A construction firm's relationship with a professional bond producer is an ongoing relationship. The professional bond producer understands the changing dynamics affecting a surety's willingness to support a firm's business, and the producer strives to create, nurture and maintain a long-term, successful relationship between his or her client and the surety company. The professional bond producer serves as a trusted advisor and becomes an integral part of the firm's external advisory group, which includes attorneys, accountants and bankers. The professional bond producer, in turn, can be an excellent referral source to ensure that a firm has the right set of construction-experienced external advisors for continued business viability and growth of surety capacity.

Choose Carefully

A firm's affiliation with a surety bond professional should be initiated with careful consideration and grow into a relationship that's based on mutual respect and trust. An ongoing relationship means the firm will have the benefit of the producer's vast surety expertise, extensive marketplace knowledge, and in-depth understanding of individual needs and capabilities. So, how do you pick the right producer?

A firm's affiliation with a surety bond professional should be initiated with careful consideration and grow into a relationship that's based on mutual respect and trust.

What to Look For

Proven Integrity

- Reputation and respect within the industry
- Solid relationships with surety underwriters
- Dedication to the contractor's long-term success

Specialist Expertise

- Mastery of construction management and financing
- Detailed ability to analyze financial statements, work in progress and cash flow
- Knowledge of construction practices, typical construction terms and conditions, and applicable laws and regulations

Broad Business Knowledge

- Awareness of local, regional and national construction markets
- Experience in strategic planning and management practices
- Involvement in and support of local and national construction and surety industry associations

When a construction firm qualifies for a surety bond, that bond assures everyone associated with a project that the bonded firm has the necessary skills, experience and capital to perform the contractual obligations and to do so in a timely manner. Earning surety credit, in fact, reinforces a firm's reputation among its peers and customers that it is a quality, committed firm. And the best way to qualify for surety credit is to work with a professional bond producer who knows the intricacies of the bonding process and the nuances of the surety marketplace, and can match the firm with a surety company interested in working with a firm of its size and type.

For names of professionals specializing in surety bonds in your state or locality, contact the National Association of Surety Bond Producers (NASBP) at 202-686-3700 or visit the "GET A BOND" link on the homepage at www.nasbp.org. ■

Mark H. McCallum is CEO of the NASBP located in Washington, D.C. NASBP is an international association of companies employing professional surety bond producers and brokers. Before assuming his role as CEO, he served as NASBP's general counsel and director of government relations, directing its government relations, industry relations, legal and other functions. McCallum has held senior staff positions with the Associated General Contractors of America and the American Institute of Architects. He was named an ENR *Top Newsmaker of 2015.*