2010 SURETY MARKET REPORT

SURETY INDUSTRY PLAYS VALUABLE ROLE, ESPECIALLY IN A DOWN ECONOMY

Economists surveyed by the National Association for Business Economics project the U.S. gross domestic product will expand by 3.2% and that consumers will increase their spending in 2010 and 2011. U.S. unemployment and inflation are ticking down. These indicators are positive signs for the U.S. economy, but the construction marketplace should remain patient. Recovery for this industry will be slow and painful.

The construction market lags about a year and a half behind the overall U.S. economy. The U.S. Census Bureau estimates total non-residential construction spending during April 2010 to be 16.1% below April 2009's seasonally adjusted rate. Construction unemployment, according to the U.S. Bureau of Labor Statistics, was 21.8% in April, an improvement over March (24.9%) but still a mountain compared to the overall U.S. unemployment rate of 9.9% in April.

The housing rebound, which still is struggling, will be one of the first indicators the construction market is moving in the right direction. Another leading indicator of non-residential construction spending, the U.S. architecture billings index, was up 2.4 points in April, the third consecutive month the index has risen. But other factors also must be considered: the continued credit crisis, state budget deficits and the health of other economies around the globe, to name a few.

The surety industry plays a key role in the construction market. This industry is uniquely situated to see the trends in the construction market and how such trends will affect surety availability. Executives from some of the leading surety companies and bond agencies say construction-market difficulties will continue through 2011, but that surety capacity is available to meet the needs of the construction market. They warn, however, that surety losses are anticipated, as contractors continue to compete for fewer projects. ➔

MARKET OVERVIEW

Small (Under $10 million)

Surety availability abounds in the small market. "Price and terms are very competitive due to the pressure of reduced writings as a result of the economic downturn in construction and a continued favorable financial performance of surety carriers," says Thomas Kunkel, president of Travelers's bond and financial products and Surety & Fidelity Association of America's Board chairman. David Hewett, executive vice president of Zurich Surety Credit and Political Risk, adds, "Many sureties are looking to protect their top line results by supporting their customers in this segment."

Other surety companies also have entered this market, providing more capacity. Today, almost every major surety has a program to facilitate access to bonding for small contractors. "Surety availability for this segment has never been better," says Gerald Leach, president and chief executive officer of Old Republic Surety Group. "While it certainly is true that the vast majority of companies are performing solid underwriting, it also is true that in almost all instances, companies are expanding their market availability to include small contractors consisting of minority, women and disadvantaged businesses, as well as start-ups."

Furthermore, the U.S. Small Business Administration (SBA) Surety Bond Guarantee Program has been expanded under the American Recovery and Reinvestment Act (ARRA), providing even more opportunities for small contractors, and the surety industry is united in its efforts to make these enhancements permanent. There are other bonding assistance programs for small contractors. For example, the U.S. Dept. of Transportation recently launched a Bonding Education Program based on SFAA's Model Contractor Development Program (MCDP). The MCDP provides education, placement and technical assistance to help small and emerging contractors access surety bonding, while providing one-on-one interactions with bond producers, underwriters and other professionals who work with these contractors to assemble complete bond applications.

TOP 10 WRITERS OF SURETY BONDS—2009*

	Companies	Direct Premium Written (Millions $)
1.	Travelers Bond	$924.2
2.	Liberty Mutual Insurance Group	$723.2
3.	Zurich Insurance Group	$486.8
4.	CNA Insurance Group	$406.1
5.	Chubb & Son Inc. Group	$277.0
6.	Hartford Fire & Casualty Group	$181.0
7.	HCC Surety Group	$165.2
8.	International Fidelity Insurance Co.	$147.1
9.	ACE Ltd. Group	$109.0
10.	The Hanover Insurance Group	$100.1

*Includes contract and commercial surety

Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States & Territories, Canada & Aggregate Other Alien," 2009 (preliminary). Additional information and reports are available for purchase from the SFAA website at www.surety.org. See "Statistical Services," then List of "Statistical Reports."

"Smaller firms must demonstrate a certain level of experience, sophistication and have access to capital in order to obtain surety support," says Michael J. Cusack, senior vice president, managing director and operations board member of Aon Construction Services Group.

Middle ($10 million-$100 million)

The situation for the middle market is much the same. "Like the small marketplace, there is more than adequate surety capacity in the middle market, partially because there is little work available," says Michael P. Foster, executive vice president of Merchants Bonding Co. (Mutual).

Contractors in this market were faced with declining backlogs through 2009 and a scarcity of new work. Well-capitalized companies had to look harder for new work at acceptable margins. Many well-managed firms, knowing that acceptable work would be scarce, made tough decisions on cutting overhead early on in the crisis and have delivered acceptable financial results.

The capital structures, reinsurance arrangements and net-retention strategies of many sureties support business plans that are focused on developing relationships with construction firms with sales in the $50 million - $150 million range.

Large ($100 million-$250 million)

While the general conditions for the small and middle markets also exist in the large marketplace, there are fewer surety competitors (both primary and reinsurers) supporting this segment due to volatility stemming from the size of the loss potential relative to the surety premium. "This segment may, therefore, be more susceptible to a turn in surety results and a possible restriction of capacity," explains Travelers' Kunkel. "Currently, however, this segment, like the small and middle, is fairly competitive."

Many contractors enjoyed strong backlogs entering 2009, but like contractors in other segments, found it difficult to secure new work at acceptable margins. "Several sureties continue to offer capacity in this segment and compete for this business because there are a large number of successful companies in this category," Zurich's Hewett says.

Mega (Over $250 million)

Surety capacity for the jumbo market is limited to a few sureties. In this segment, contractor defaults are less frequent but can be significant when they occur; therefore, this segment requires additional capital to underwrite.

Sureties with sufficient capacity actively compete on either a sole surety basis or on a co-surety basis to provide the capacity necessary. Some of these mega-projects require various joint-venture structures so that both the surety and the contractor to feel comfortable with the significant risks that these projects present. "Competition is vigorous, and sureties are stepping up to provide capacity for these mega-jobs for well-qualified contractors and joint ventures," Zurich's Hewett says.

"Larger contractors," adds Aon's Cusack, "have experienced

a strong track record of earnings, growing balance sheets and expanding backlogs. The stronger balance sheets and healthier backlogs will help sustain larger firms through this down cycle and enable these companies to maintain critical staff and be properly positioned for the recovery."

In this market, all contractors are experiencing difficulty securing new work, but the declining backlogs have not yet impacted the balance sheets of the nation's largest construction companies.

CONTRACTOR DEFAULT

The construction industry continues to suffer from reduced spending, reduced public funding and, at the private end of the market, lack of demand and limited credit availability. State budget deficits and reduced tax collections have limited the funding of ongoing school, health-care and institutional-facility construction. Meanwhile, the U.S. construction market is experiencing an exceedingly high unemployment rate compared with the national unemployment rate. Furthermore, there has been a major shift from private work to public work.

These market conditions have combined to set the stage for an increase in contractor failures. While there has not yet been an unusual increase in defaults, some sureties are experiencing an uptick in contractor failures. Based on the laws of supply and demand, some contractors simply will cease to exist.

What appears to be an improvement in the overall construction economy, however, actually may be more of a process of stabilization than growth. Construction economists suggest the recovery will be slow and require a recovery in the housing market, improved funding in state budgets, added federal stimulus and further improvement in construction lending. "We're not sure the overall economy has turned around yet," Merchants' Foster says, "but, even if it has, that means we have another 18 months before the construction economy recovers."

Executives say, the difficulties experienced in the construction industry in 2009 will continue throughout 2011 and likely into 2012. "It is unlikely the state of the construction industry will show any meaningful improvement until the early part of 2012," notes Henry W. Nozko Jr., president of ACSTAR Insurance Co.

"When the construction economy finally does recover," adds J. Spencer Miller, president of Schwartz Brothers Insurance Agency and president of the National Association of Surety Bond Producers (NASBP), "it will not recover to the extent everyone was accustomed to in the past."

This year may prove to be the low point in this difficult cycle as the rising GDP will gradually begin to absorb the excess capacity in the private residential and commercial building markets. "I am hopeful that, by the second quarter of 2011, we will begin to see a modest improvement in the construction economy," says Doug Hinkle, chief underwriting officer at CNA Surety.

Contractors that are able to maintain a sense of realism and proactively respond to the current construction environment will be successful not only in this market but also in all market conditions. The ability to maintain discipline in the face of increased bidding competition and few bidding opportunities will be key. "It takes courage and wisdom to make the very difficult decision of cutting overhead—even the choice of losing good people—in order to be positioned to withstand a prolonged reduction in revenue," says Anthony Romano, senior vice president of Chartis. "Making difficult decisions today will propel the firm forward in the future."

VALUE AND PROTECTION

Losses to project owners—both public and private—due to contractor default are largely preventable. A surety's prequalification of a contractor constitutes an invaluable service in the bonding process. The surety performs an in-depth investigation of the contractor's overall credit worthiness, financial strength and ability to perform the project under consideration. "The owner benefits from the surety's prequalification process and the guarantee that the project will be performed according to plans and specifications within the time frame required," Travelers' Kunkel explains. "The owner and general contractor are further protected from the contractor or subcontractor's inability to pay for labor or material costs."

The value of surety bonds is never more important than in uncertain economic conditions. The very real challenges that today's difficult economic climate brings to project owners in terms of contractor default, subcontractor default and payment bond risk reinforces the need for surety bonds. "In difficult times, it is vital to help reduce risk to make certain well-qualified contractors and well-qualified subcontractors perform the work and deliver the job on time and on budget," Zurich's Hewett says. "In today's economic reality, project owners cannot afford the risk of project defaults."

With profit margins providing little room for error, contractors can protect themselves from subcontractor default by requiring subcontractor bonds. "It is the best practice for risk mitigation," says Merchants' Foster. "A subcontractor bonded by a trusted surety is key for general contractors to protect their own balance sheets."

"Having the subcontractor bonded," adds Mary Jeanne Anderson, president of Hanover Surety, "will give the general contractor a well-vetted partner through the surety underwriting process and, if problems do occur, quick action by the surety to prevent delays and protect the entire project for the GC."

When owners require performance and payment bonds on their projects, they receive an instrument that helps assure contractor performance and payment of a contractor's subcontractors, laborers and suppliers. "When a surety provides a bond, it makes an affirmative statement to an obligee that, based on its due diligence, the surety is confident that a contractor has the technical ability and financial strength to successfully complete the obligation," says William A. Marino, vice chairman at Aon.

ACSTAR's Nozko concurs, "There has never been a time when a surety bond was more important."

SURETY OUTLOOK

Results for the surety industry as reported by SFAA continue to be favorable. According to SFAA's preliminary 2009 "Top 100 Writers of Surety Bonds—United States & Territories, Canada & Aggregate,

Other Alien," the top 100 surety writers posted a 20.3% loss ratio. Executives, however, predict surety losses to grow as contractor work programs wind down and the replacement of work in the current marketplace remains constrained by the amount of new work available. If this cycle develops as predicted, the amount of loss activity will determine how surety companies react. "If severe, it could impact capacity, but at this point it's not possible to predict whether the industry will experience a soft or hard landing," Travelers' Kunkel says.

Surety executives expect surety losses to increase because of the severity of the economic recession. Schwartz Brothers' Miller says, "Most surety company management teams expect 2010 and 2011 to experience increased frequency and, more than likely, larger claims."

While there will be increased loss activity, overall surety results for the majority of sureties still should remain positive for 2010. "But 2011 results likely will be worse than 2010, particularly if we do not see improvement in the private-sector economy," says CNA Surety's Hinkle.

So far, the frequency and severity of losses have not been greater than anticipated and have been mitigated by underwriting discipline, as well as the industry's focus on advising contractor clients on such issues, from overhead management and maintaining estimating discipline to identifying and addressing onerous contract provisions.

"I'm bullish on the surety industry," adds David Finkelstein, executive vice president of Surety, Arch Insurance Group. "With the amount of infrastructure necessary to rebuild the U.S. over the next decade, the prospects are very favorable. The value we provide as a surety in creating strong relationships with contractors, coupled with a growing economy, creates a positive outlook."

Marc Ramsey is the communications manager for The Surety & Fidelity Association of America (SFAA), www.surety.org, and handles communications for the Surety Information Office (SIO). SIO is a joint initiative of SFAA and the National Association of Surety Bond Producers (NASBP), www.nasbp.org. Ramsey can be reached at mramsey@surety.org or 202-778-3629. For brochures, presentations and other information, visit www.sio.org.

EXECUTIVE PERSPECTIVES

How has technology affected how you have conducted business and served your contractor clients?

Thomas Kunkel
Chairman of the Board, The Surety & Fidelity Association of America (SFAA)
President, Bond & Financial Products, Travelers

Automation is a critical investment for both the surety carrier as well as the agent/broker representing the carrier. Technology can be used to provide efficiency, data for analysis and improved service, including the support of electronic bidding and value-added capabilities for the contractor. Technology has enabled an optimized work flow, streamlined processing and the ability to perform both underwriting and premium processing functions in a paperless environment. Use of data provided through technology has enhanced credit analysis abilities and improved decision-making. Technology has enhanced service levels and response time, thereby enabling Travelers to provide more attention to delivering value-added services to contractor clients. Reports such as a Peer Review Analysis Report, Gross Profit Margin Report and Backlog Utilization Report are provided to contractor clients so that they can make more informed decisions. Travelers also has adopted a business-to-business (B2B) technology platform with our major agent/broker trading partners to further enhance our mutual premium processes, thereby reducing operating expenses.

Anthony Romano
Senior Vice President
Chartis

Technology, whether in support of a paperless paradigm or to foster constant communication through the use of laptops and BlackBerrys, has drastically changed service standards and expectations. Today, the surety industry supports the construction community on a 24/7 basis. The days of waiting for "papers" and communicating through dictated letters are long gone. Business is now transacted in moments based upon flashes of information and short e-mail blasts. Although this has enabled surety companies to do more with less and improve the efficiencies within their business processes leading to better-served clients, it has also to some degree infringed upon a very important element of the underwriting process: measured thought. There is something to be said for having the opportunity to consider a decision over a few days' time. The ability to approach a request from many different sides—versus reactively responding to immediate deadlines—provides clarity of thought that is sometimes lost in the heat of the moment when response times are compressed. Although it is hard to imagine us going back to the days of old, in fact, time will only move faster as technology continues to develop. That said, we all have to find ways to slow down the process, at least to some degree, in order to ensure our decisions are well-considered, far-reaching and in the best interest of all parties concerned.

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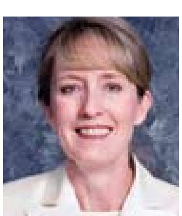
What are good contractors doing to manage through the construction recession?

Timothy Mikolajewski
President

Rod Williams
Executive Vice President
Chief Underwriting Officer
Liberty Mutual Surety

Experienced contractors are not strangers to construction cycles. A successful contractor implements sound business plans, monitors key metrics and demonstrates flexibility in adapting quickly to changing environments. The reality most contractors face in today's economic environment is decreased revenue and profit margins, limited bank credit access and an underutilized workforce and equipment plan. Managing overhead remains a critical success factor. Those contractors who anticipated a slowing market and preemptively adjusted their operations to ride out the recession will fare the best. Examples of such actions include reductions in equipment fleets and related debt earlier in the cycle, as the ability to sell equipment and pricing diminished as the recession unfolded. Those slow to adapt faced heavy debt leverage ratios and struggled to generate the revenue needed to fund debt on unused equipment. Managing bank lines also has been important. Smart contractors pursued longer-term lines when possible and minimized the use of credit lines to ration borrowing capacity, should it be needed later. Forward-looking contractors also are adopting BIM and integrated project delivery methods, bringing together contractors, owners and architects. As more owners seek to mitigate exposure by transferring risk through contracts and bond forms, contractors need to facilitate strong communications and build relationships with key partners. Maintaining frequent and transparent communications with a surety is especially critical as sureties can share a national perspective on construction trends and mediate emerging disputes with owners on affirmative claims. Overall, contractors should have a flexible plan and be ready to adapt and execute it consistent with market trends.



Mary Jeanne Anderson
President
Hanover Surety

The challenge for contractors in this economic environment is to not only survive but to actually thrive. Financial management is the key. There is a new discipline needed in acquiring work at a reasonable price and terms balanced with the willingness to make overhead cuts when the work does not materialize. Taking work below cost just to generate cash flow is not a sustainable option, even if that is what the competition is doing. It is not easy, and many contractors will not survive because they took work too cheaply, fell victim to unreasonable contract terms or did not make the necessary overhead adjustments in time. Operating within the terms of the contract is important regardless of past relationships and practices. A contractor needs to be particularly attentive to collecting money when it is due and not forbearing on collection, as getting behind in collecting money—only to find the funds are not forthcoming—can lead to a chain reaction of problems. Relationships between owners and contractors, generals and subcontractors, will be tested, but the contract terms will define the relationship in the end. Navigating the recession successfully will require good advisers, including independent agents with a surety specialty, a construction-focused CPA, a banker who understands the business and a contractor-oriented attorney. Add a flexible and knowledgeable surety company and team to the equation and contractors will have the benefit of the best advice available.

David Hewett
Executive Vice President
Zurich North America Surety

Even through difficult times, we continue to see good contractors perform well. Many of these firms have put in place systems and cultures that allow them to excel at times like these. We also recognize an organization that has built such a culture is not built overnight. First, these firms quickly recognize and accept times have changed. Moreover, while these are tough decisions, we do recognize that, as a sector quickly shrinks, the firms that respond to this contraction live to fight another day. At the same time, they examine their core competencies and use these to carefully explore new opportunities. How a firm manages this process is extremely important. We find firms that are proactive are the most successful during these times. What this translates into for each individual company varies. As it specifically relates to surety, open and continuous communication is more important than ever.

Doug Hinkle
Chief Underwriting Officer
CNA Surety

Successful contractors have been implementing business plans that were put into place before actually experiencing the current weak construction economy. One key point in those plans include budgeting expected volumes of work realistically. These firms have not slipped into that downward cycle of trying to do more and more work at less-than-adequate margins. With a realistic revenue projection, they have reduced and/or structured overhead accordingly. These companies know who their best people are—the objective is to optimize with lower overhead without sacrificing quality of work—and they know in advance the type and size of work that has been historically the most profitable. This is good information in the analysis of the likely type and size of work that will be available.

Also, these firms review the business operation, specifically estimating and field. Highly consistent and accurate bids are needed from the estimating department and an emphasis on field productivity is more important than ever in order to squeeze as much profit as possible out of the work that is available. Firms must proactively manage leverage with a focus on liquidity. They have reduced to the bare minimum capital outlays for fixed assets; many have sold excess equipment. Maintaining strong liquidity in the business creates an advantage over other contractors who are burdened with excessive overhead and equipment debt, which often leads to buying work and cash-flow problems.

Gerald Leach
President and Chief Executive Officer
Old Republic Surety Group

The good contractors who are successfully managing through the construction recession are doing so because they are good business people who have planned ahead and have been able to minimize their debt load. First and foremost, they were proactive at reducing overhead that could not be absorbed as the economy continued to erode their volume. Tough choices had to be made with respect to staffing, and they made them. The second thing that good contractors are doing is limiting or completely eliminating hard-dollar debt. When volume and profit percentage drop, contractors with heavy debt loads tend to be the ones that fail. Good contractors are the ones who anticipate this and have taken a very conservative approach to their debt; the ones without large debt loads are the ones who can be more selective in job selection. The third thing that good contractors have done is to stay within their abilities and not panic. Usually when a contractor becomes overly aggressive in type, size or location of a job, the risk of failure magnifies. Good contractors recognize this danger, and because they have managed their company wisely, they can afford to be more reflective in the work they go after.

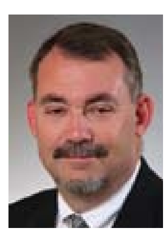
What will be the top issues for the construction surety industry over the next five years? Why?

David Finkelstein
Executive Vice President
Surety Arch Insurance Group

Understanding the ramifications of changing terms and conditions that contractors will have in their contract with owners will require greater sophistication to successfully complete projects on time, on budget and profitably. Efficiency guarantees and onerous conditions will create greater litigation and misinterpretation over the role of the contractor, architect, obligee and surety. "Who is responsible for what" will create the need for far more upfront alignment prior to the start of the project for it to be successful and avoid lawsuits. With the large budget deficits at the federal and state levels, financing of projects will need to be better understood and additional methods of procurement will be necessary. The creation of different project financing may limit the number of contractors with the wherewithal to appropriately respond to bids. It will be incumbent upon the sureties to assure that the proper due diligence and prequalification is performed to avoid claims.

Michael P. Foster
Executive Vice President
Merchants Bonding Co. (Mutual)

The primary issue for the construction industry over the next five years will be the ability to maintain underwriting discipline in a time of unparalleled changes in construction economic activity. The lack of construction activity is forcing contractors to thoroughly review and adjust sound business plans. Contractors are being forced to pursue projects outside of their area of expertise, which could apply to project size, geographic area, customer target (public vs. private) or type of work. Surety underwriters are being asked to support "adjusted" business plans for new or existing accounts. Additional challenges will be faced when the cycle turns and contractors have opportunities to grow but will not have the necessary personnel in place due to cuts that were made during the slowdown. The construction surety industry will continue to attempt to deal with the challenge of supporting small and emerging contractors. As an industry, we need to do a better job of educating both contractors and owner/obligees about what a surety bond is, what needs to be in place for an account to secure surety support and how these bonds protect obligees. Technology continues to be an issue for the construction surety industry. We have made significant advances in recent years but still have a long ways to go. We need to streamline the process of information exchange among contractors, surety producers and surety companies.



J. Spencer Miller
President, National Association of Surety Bond Producers
President, Schwartz Brothers Insurance Agency Inc.

The surety industry must continue to impress upon all levels of government its place in the procurement of construction and related services and the importance of its assurance. The industry must educate the public about the critical role surety bonds play. The prequalification ability, backed by claims-paying capability, is essential to precious taxpayer funds and to ensure delivery of contract performance. Given the state of federal, state and local budgets, saving taxpayer funds cannot be undervalued. Further, the surety industry must continue to seek out the best and brightest people and train them accordingly. Firms must continue to invest in education and technology to allow their teams to flourish. The industry also must develop and share its best practices with its customers to give them more understanding

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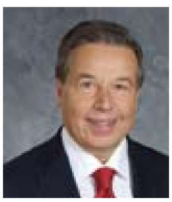
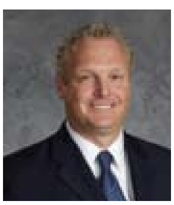
of where they are and what they can improve. Also, given the predictions of increased claim activity for the next few years, it is paramount claims be handled promptly and properly. A major part of claims handling is communication, not only communication of the day-to-day issues involved in handling a claim, but also education of the parties as to what the process can and cannot accomplish. Finally, when a project has been successfully completed with surety involvement, we must tell the story.





William A. Marino
Vice Chairman

Michael J. Cusack
Senior Vice President, Managing Director and Operations Board Member
Aon Construction Services Group

Continued profitability of the business is key. Surety is a very high-risk line of business for an insurance company. Generally, aggregate surety premium writings are low relative to their entire premium base. Like every business, within insurance companies, product lines compete with each other for the allocation of the capital necessary to support their respective business plans. If the risk/return prospects of a surety operation are not viewed favorably by the senior management of an insurance company, they will not be allocated the capital necessary to support their operations. Alternative procurement also is important. As the PPP model gains momentum in the United States, sureties need to take a lead role in establishing the necessary definition to the allocation of risk among all the stakeholders in the transaction. In order for surety to become the preferred means of addressing the construction-related exposures in an alternative procurement project, sureties may need to develop a product and an underwriting appetite to assume exposures beyond those currently contemplated in the traditional procurement model. Adequacy of human resources is another critical area. Like every business, the surety industry is having a difficult time attracting and retaining top talent, which is driven by budget constraints and competition from other industries looking for employees with comparable skill sets. If a surety company does not have the people it is confident have the necessary skills to adequately underwrite risk, the company will not be willing to support those transactions.

Henry W. Nozko Jr.
President
ACSTAR Insurance Co.

Insolvencies may be the top issue facing the construction industry. Prime contractors will need to heighten due diligence in their selection of subcontractors as the rate of financial failures of subcontractors most likely will increase during the next five years caused by the ravaging effects of the severe recession of 2008, 2009 and 2010. Likewise, subcontractors must heighten due diligence when entering into subcontracts with prime contractors. The recession of 2008-10 will cause an increase in prime contractor failures during the next five years that could result in project and payment failures, severely affecting the project subcontractors. Another issue facing the construction industry will be the availability of working capital credit, which will remain constrained during the next five years. Contractors should concentrate on securing long-term credit (term loans of seven years or greater) while interest rates are low to avoid the effects of rising interest rates, which most likely will occur during the next five years, significantly increasing a contractor's operating expenses. Interest rates may increase by more than 500 basis points over the next five years.

TAKE STEPS NOW TO PREPARE FOR BETTER TIMES

By Mike Noe, Travelers Construction Services, Bond & Financial Products

Construction firms surviving the economic quagmire of the past couple of years often have scrambled to adjust to a rapidly declining backlog and reduced prospect of new work. They have sometimes slashed their workforce and overhead to reduce costs and have cut their bid margin to remain competitive. Now, as hints of recovery are under way, it is important for contractors to remain focused, take stock of their situations and plan strategically to be well-positioned for the future.

Some of the preparation means looking beyond the next job and thinking strategically about how to build readiness at a time when holding down costs is still imperative. Here are some steps to consider.

1. **Choose projects carefully.** Now is not the time to take on projects that involve high risk and low return. Bid the job, not the competition. Companies should look for opportunities where they execute on their strengths and build quality work, with an acceptable margin and return for the risk involved. Risk mitigation—including contract review, effective prequalification and bonding of subcontractors and vendor risk—will help prevent problems down the road that otherwise may reflect poorly on the firm and reduce profits over the long term.

2. **Invest in your team.** With jobs continuing to be scarce, construction companies can afford to be *Continued on page 15 →*

Take Steps Now *Continued from page 12*

picky about applicants and existing staff. Find and keep the best people, and then invest in them to build their skills and their loyalty. Make sure certifications are renewed when necessary, upgrade skills with training as appropriate, and stay focused on safety to provide the kind of environment in which workers enjoy and excel. You have an obligation to send home every employee in the same condition in which they arrive.

3. Review equipment needs and invest in maintenance. Inventory of unused or unneeded equipment may be causing a drain on your business. Carefully and realistically review your equipment needs and consider trimming inventory. Additionally, cutbacks in the past few years have caused some firms to reduce costs by deferring maintenance of heavy equipment. But when the pace of work picks up, companies need to know they can rely on their equipment functioning at full capability. An unexpected breakdown can cause costly delays and impact the reputation for dependability upon which a company strives. Lastly, the risk to worker safety increases when equipment does not function as it should. Creating a schedule of regular maintenance—and then sticking to it—is an important preventive measure.

4. Avoid debt overload. The boom times created a mind-set in which taking on debt seemed the best way to grow a business. The many bankruptcies in a number of industries were often companies that could not meet payments once their cash flow was disrupted. These bankruptcies have brought a new sensitivity to the business world when it comes to debt. The lesson learned is that construction firms should maximize liquidity when possible. When borrowing is necessary, debt should be paid down as quickly as feasible to preserve flexibility for future projects. Having an available line of credit is important in today's economy, but planning cash flow without reliance on the bank is a much safer bet.

5. Strengthen partnerships. Construction firms rely on a number of relationships to make their business successful: suppliers, subcontractors, agents and brokers for insurance carriers and bond providers, accountants, bankers and attorneys. Seek relationships that provide value to your business. When a company handles such relationships on a case-by-case basis, it is less likely to build the trust and long-term view that can tide it over when times are bad. For example, a surety-bond underwriter that understands a construction firm's strategy for the future and sees the value of working through difficult times together is more likely to be flexible when a company is facing a challenging project or change in the work program. Smart construction firms strengthen their partnerships by sharing information, involving the surety and other experts in their business planning, and working together closely for mutual success.

Construction company leaders who have made it this far can pat themselves on the back for surviving one of the toughest periods they will probably ever face. However, to move out of the economic crisis beyond survival to success, it is important to take steps now to prepare for better times ahead. Working closely with partners, including surety-bond experts, can help contractors stay ahead of the competition and be well-positioned for the future.

Mike Noe is executive vice president for Travelers Construction Services, Bond & Financial Products. He can be reached at (860) 277-0111 or mnoe@travelers.com.

FROM SOUP TO NUTS: THE ADVANTAGES OF USING BONDED CONTRACTORS AND THE SURETY'S ROLE IN CURING DEFAULTS

By Jason Stonefeld and Nick Hyslop, Liberty Mutual Surety

Private construction projects sometimes present owners with significant risks. Requiring otherwise eligible contractors to furnish performance and payment bonds as a condition for awarding a contract is one way to mitigate at least some potentials risks. Below are some benefits to requiring bonds as well as some other ways owners, contractors and sureties might work together to further mitigate risks. Though the overwhelming majority of construction projects do not result in default and termination of the general contractor, owners and contractors can benefit from understanding the surety's role in bonded construction projects.

CONTRACTOR PREQUALIFICATION AND PRE-CONSTRUCTION RISK MITIGATION

A surety bond can benefit the owner even before the project is awarded. Although not a substitute for an owner's own evaluation of a contractor's ability to deliver on a particular contract, a surety typically evaluates during the underwriting process, a contractor's capital, capacity and character before committing to issuing bonds. The surety's review attempts to separate the more financially strong and capable contractors from those undeserving of surety credit.

This prequalification also can benefit contractors. It is often stated by contractors that the best job it ever had was the one it declined to build; however, it is very difficult for a contractor to turn down a job that appears lucrative on paper but may be outside the scope of its capacity or expertise. By declining to issue a bond to a contractor, the surety underwriting process reinforces the discipline of a contractor's business model, thus reducing the risk the contractor will take on more than it can handle. *Continued on page 16 →*

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Prior to awarding the contract, the owner can use the performance bond as a risk-mitigation tool by taking the following steps:

- Confirm that a bond program is in place. As a prequalification condition, an owner might consider requesting that the contractor provide a letter from a qualified surety indicating the surety has issued bonds for the contractor in the past and would consider issuing performance and payment bonds for the contract at hand. Although the letter will not actually commit the surety and will typically place underwriting and other conditions on its issuance of final bonds, it does provide an indication that a surety has developed some confidence in the contractor's ability to complete the contract.
- Require a bid bond. If the owner intends to rely on a bidding process to choose a contractor, it might consider requiring bid bonds from otherwise qualified contractors. Typically, a bid bond provides an owner with some protection from financial loss in the event the lowest responsive bidder fails to enter into an awarded contract.
- Confirm the bond(s) are signed with valid power of attorney and verify validity of bond(s). In the event the owner chooses to require either a bid, performance or payment bond, the owner should carefully review the bonds to make sure they contain all required signatures and that all bonds are accompanied by a valid power of attorney for the person executing the bond on the surety's behalf. An owner also should independently verify the validity of the bond by directly contacting the surety.

CONTRACT PERFORMANCE

Once the owner has awarded the contract and received the performance bond, work can commence. Though no job is perfect, the vast majority are completed by the contractor and accepted by the owner. In those few cases in which the owner begins to have concerns about the contractor's ability to complete the work, the surety's role is not limited solely to post-default remedies; the surety can continue to play a role prior to any formal declaration of default.

Should an owner have a concern regarding the contractor's performance, the owner should make such concerns known to the surety. Thus, use of a bond form that requires the parties to conduct a meeting involving the surety before a default termination can be beneficial. The surety may be able to make some informal observations and facilitate productive dialogue among the parties.

When expressing the basis for its concern, the owner should state specific facts and contract provisions that lead the owner to conclude the contractor may be in default. The bonded contractor likewise should be ready to discuss with the surety its factual basis in dispute of the owner's allegations of default. The surety will be requesting documentation from both the owner and principal to investigate the situation.

In an exceptional case, the contractor may advise the surety it does not have the ability to complete the project. The contractor then might send a letter to the owner, declaring itself in default and requesting the owner to work with the surety. Like receiving a hold-funds letter, the owner should comply with this request, so as not to inadvertently exonerate the surety's liability.

Of course, avoiding project defaults is in the interest of both the owner and contractor. The following actions undertaken by the owner can help projects run smoothly.

- Ensure that project designs, plans and specifications are current and complete.
- Use even-handed contract language and avoid contract terms that would be objectionable if included in the bond.
- Use a reasonable bond form.
- Give timely notice to the surety if material issues arise on the job.
- Be fair in expecting how quickly the surety can respond to complicated disputes.
- Expect the surety to keep performance consistent with the contract; a default is not the time to gain a windfall at the expense of the contractor and surety.
- Provide information, documentation and access to owner personnel to aid in the surety's investigation.
- Pay per the terms of the contract.
- Use attorneys who understand construction and know how bonds operate.
- Communicate consistently and in a timely manner with both the contractor and surety.
- Provide the contractor with the opportunity to cure a default before declaring termination.

POST-DEFAULT: THE SURETY'S ROLE IN RESPONSE TO A CLAIM

Despite all actions taken thus far, if the contractor does indeed default on a contract and the owner makes a claim against a surety's performance bond, the surety will commence a more formal investigation and, depending on the written terms of bond and underlying construction contract, give consideration to various options, which may include:

- Having the contractor complete the job, potentially with surety financial and/or technical resources.
- Having another contractor complete under the surety's administration, called a "re-let."
- Tendering another contractor to the owner under the owner's administration; or tendering a payment to the owner and the owner procures a completing contractor.
- Denying the claim and choosing not to procure job completion but reserving its rights and those of its contractor during job performance. Upon completion, the contractor would pursue a claim of improper termination against the owner.

Should the surety elect one of the first two options, the owner, surety and contractor will continue to have an interest in the completion of the contract. The owner can assist by continuing compliance with the contract documents, and the contractor can continue to provide information about *Continued on page 23* →

ALTERNATIVE PROJECT FINANCING METHODS CREATE NEW RISKS TO CONTRACTORS: A SURETY PERSPECTIVE

By Tom McClellan, Zurich Surety Credit and Political Risk

Much has been written and discussed regarding the inability of federal, state and local governments to finance and deliver needed improvements to the U.S.'s aging infrastructure. Some experts estimate the need at $1.6 trillion or more over a five-year period. The private sector will no doubt continue to play a role in the delivery and financing of public infrastructure.

To date, the most popular methods used to enlist the private sector in the financing and delivery of public infrastructure have been public-private partnerships (P3) and "gap" financing. These alternative procurement methods have great potential to unlock a vast private financing market and bring many needed projects forward sooner than would be possible using traditional public-sector funding. Changing the financing risk to the private sector represents a paradigm shift for contractors and sureties that requires additional analysis to identify and manage the resulting risks.

PUBLIC-PRIVATE PARTNERSHIPS

Public-private partnerships are not a new concept, having been successfully employed throughout the world as a means for delivering infrastructure improvements without requiring government agencies to leverage their balance sheets with debt or increasing taxes. The essence of the P3 is that a private entity agrees to design, build, operate, maintain and finance the ultimate improvement in return for a long-term lease or concession that allows for the generation of a predictable revenue stream. Many state legislatures have approved the use of P3 agreements, and more states are expected to follow.

A contractor and surety partner considering such projects need to fully understand and evaluate the role the contractor plays and the new risks they assume. In a typical P3 there are three primary levels at which a contractor can participate:

- The concessionaire with the direct contractual relationship with the public body.
- The design-builder under contract to the concessionaire.
- A subcontractor to the design-builder.

It is typical at the concessionaire level for security of some sort—usually in the form of a letter of credit—be provided to the public body, which serves to guarantee the obligations of the concessionaire. It is important the contract undertaken places responsibility on the contractor for the risks and activities it is best suited to accept. Details regarding availability of financing, rights of the contractor in the event of the concessionaire failing to meet its obligations, and limitation of long-term warranties or operations and maintenance agreements are key elements to evaluate.

'GAP' FINANCING

Utilization of gap financing solicitations by state departments of transportation and other public bodies has been growing in the past year with a number of states expressing interest in using such procurement methods. In a gap, or deferred, financing scenario, the contractor is asked to shoulder some of the burden of financing the project in return for payments that will extend beyond the physical completion of the project. Unlike the typical P3 where the concessionaire has rights to a defined revenue stream for a specified period of time, under a gap-financed project, the contractor does not have tolling rights or revenue generation opportunities that can be pledged to secure financing.

To date, it has been difficult for contractors to arrange for non-recourse financing to fund the gap as a result of the inability to assign receivables to a lender in a manner that allows for lending solely secured by the receivables to be collected. The result is that contractors bidding on these projects have to consider either corporate guarantees or asset pledges in order to secure funding or consider using their own equity and working capital to fund the gap.

Absent outside funding with terms and conditions acceptable to the contractor and surety, the surety underwriter is asked to rely on the financial strength of the contractor as protection against the gap exposure. While there are many contractors who possess the financial strength to entertain this risk, both the contractor and the surety need to understand and evaluate the impact on the working capital and financial flexibility of the contractor. Converting cash resources or using existing credit lines to prosecute a contract in return for a long-term receivable necessarily impacts the analysis of a contractor's balance sheet and ultimately, the ability of an underwriter to provide surety support. While relying on the balance sheet of a contractor may be a solution for some projects, there comes a point at which it is not a sustainable model for even the largest and most financially secure contractors.

This new paradigm in project delivery will create opportunities as well as challenges to the historical status quo for contractors, sureties and lenders alike. Key considerations of the surety underwriter and its contractor client include structuring financing packages which do not make it necessary for the contractor to incur either direct or contingent financial obligations that could have long-term negative balance-sheet impacts and allocating risks and responsibilities in accordance with the expertise and historical role of the contractor and surety. To overcome these challenges, project owners, concessionaires, contractors, lenders and sureties must work together to create the contractual and financial structures that will best position projects for ultimate success.

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BOND FRAUD IN A DOWN ECONOMY

By Therese Wielage, Merchants Bonding Co.

The downturn in the construction industry has created an environment ripe for fraud, and some industry experts estimate losses caused by surety bond fraud to be as much as $800 million a year. That figure is the estimate from the American Subcontractors Association (ASA), and other industry experts agree the number could be that high. Jim Schmid, national construction practice leader of forensics and investigative services for Grant Thornton, a global accounting firm, estimates that 6% to 10% of construction industry revenue is lost to various types of fraud and corruption.

Contractors and subcontractors hungry for work face increased pressure on profits, more competition for fewer projects and higher risks of insolvency, Schmid says. In addition, contracting companies that traditionally work in the private sector are venturing into the unfamiliar territory of government work. All these factors can mean greater risks for trouble. Schmid says contractors and subcontractors must be constantly vigilant, because being even indirectly linked to an act of fraud can taint a company's reputation. "If you lose your good reputation in a highly competitive economy because of fraud or corruption, you will move to the bottom of your customer's preference list," Schmid cautions.

E. Colette Nelson, executive vice president of ASA in Alexandria, Va., says, historically, instances of surety-bond fraud increase during a bad economy for several reasons. Because work is difficult to find in the private sector in which bonding is less frequently required, contractors who do not usually do government work turn to public jobs that usually require bonding, Nelson notes. Many may have a difficult time obtaining a bond for the first time, she adds. In addition, even contractors who have been bonded previously may have a difficult time in purchasing a bond in a difficult economy, Nelson notes, because the financial status of their company has deteriorated. The result is that some contractors, whether familiar or unfamiliar with bonding procedures, become easy targets for unscrupulous bonding operators who sell phony bonds, sometimes charging inordinately high premiums for bonds that offer no protection, Nelson warns.

For example, a headline in the Sacramento Bee newspaper read, "Who is Jeremy Daniel Phillips?" Phillips is the name of the mysterious agent who allegedly approved the fraudulent bond documents used to win $3.5 million worth of federal stimulus-funded contracts to install water meters in California's capital city. He used the name of a reputable bonding company on the fake bond. Payroll complaints from subcontractors and a suspicious utilities-department employee raised concerns, prompting the city to contact the surety company and uncover the fraud. Since that time, investigators report the contractor has not been reachable, there is no record of the mystery agent, and the listed notary has no record of the transaction.

A legitimate bond purchased by a general contractor protects the project owner if the work is not completed and protects subcontractors and suppliers if they are not paid. A legitimate bonding company also can help a contractor deal with unexpected financial issues. All bond beneficiaries "need to be vigilant," says Mark McCallum, chief executive officer of the National Association of Surety Bond Producers in Washington, D.C. "It's incumbent on anyone who may be affected by the bond to do the due diligence to make sure it is an authentic bond that has been truly authorized by the surety and that the surety is reputable."

"All reputable surety companies will gladly verify their bonds and help prevent obligees from becoming victims of fraud," notes Merchants Bonding Co.'s claims attorney, Mike Safris. Additionally, The Surety & Fidelity Association of America (SFAA) provides a guide for obligees to verify the authenticity of surety bonds. The guide can be accessed at www.surety.org.

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SURETY MARKET REPORT

TOP 10 NEW RISKS CONTRACTORS FACE

By Mary Jeanne Anderson, Hanover Insurance Companies

The challenges of the worst construction economy in decades present new risks to contractors every day. While some of these risks directly affect a construction business, others have a more indirect impact. These indirect threats, which often challenge the viability of the subcontractors on which a construction company relies, can be just as influential to the bottom line.

In this environment, the most successful construction company owners are actively involved in the risk management process. They work closely with professional surety-bond producers who have specialized surety expertise, provide value in their advice, insight into local, regional and national contract laws and regulations, and in managing surety capacity.

The underwriters and claims staff at Hanover Surety pooled their recent experiences and identified the following 10 issues, that are of increasing concern given the prevailing economic conditions.

1. Competition bidding work below cost. The lack of new work, coupled with low backlogs, has driven contractors to bid projects below cost with the hope of buying out projects or earning additional profit through change orders. Some will take work at any cost just to create cash flow for their operations. This type of competition makes it difficult for a responsible contractor to acquire new work. Those who bid work routinely below cost will eventually fail, creating difficulty for other contractors with whom they are working.

2. Owners and general contractors changing contract terms without notice. There has been a trend in recent years toward contractually passing risk to others. This strategy has now gone to the next level, as some owners are taking advantage of contractors so eager to obtain work that they will accept even unreasonable terms. We have seen both owners and general contractors change conditions in their standard contracts without notice, so it is wise to review every contract every time. Other owners are locking in today's low prices for the long term by converting annual contracts to multiyear obligations without escalation clauses.

3. Insufficient funds to pay for work on public projects. Availability of funding for public work is no longer a given. State and local budgets are severely stressed and public entities are running out of money, affecting the amount of new work being contracted.

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It also creates problems when the public entity runs out of funding after work has started. The contractor may be terminated for convenience, which can lead to unforeseen financial shortfalls as the termination is rarely as clean-cut as it sounds. Even when projects are funded through to completion, it has become difficult to get change orders approved and funded.

4. Slow-paying owners and less patient subs clamoring for payment create cash-flow issues. Bank facilities and contractor's cash positions are not as strong as during the boom construction years. Owners are holding onto funds as long as possible and subcontractors are less willing to sit back and wait to be paid. As a result, subs and suppliers have a hair trigger on making claims against the general contractor's payment bond. We have seen even minor creditors force accounts into bankruptcy to protect their rights to payment.

5. Banks accelerating repayment of loans due to their own financial issues. Banks have been cutting back on the amount of borrowing available to contractors for a while, often reducing lines of credit at renewal. Now there is the additional risk of a bank accelerating repayment or not renewing a line because of the bank's own financial distress. Additionally, lending institutions are far less willing to waive a default on a loan covenant than they were in the recent past. The cash-flow risk becomes even greater if the loan agreement allows the bank to offset the contractor's bank deposits to pay the amount due under the loan.

6. Contractors moving from the private-to the public-work sector. Residential and commercial work has dried up, and many private-sector contractors are turning to the public arena for work, but are unfamiliar with the extensive bureaucratic paperwork and protocols involved. Many contractors have stumbled and failed upon entering the hard-bid world of public works, even in easier times.

7. Contractors winding down operations and closing their doors. We have seen a trend toward companies winding down operations rather than continue to lose money on low-margin work and backlogs too small to carry their overhead. Most of these wind-downs have been orderly, but the contractor's ability to close out the last few jobs and respond to warranty work may be in question.

8. Contractors changing ownership without having adequate continuity plans. In two recent situations, overpayment to retiring stockholders created a debt structure the company could not sustain, and the company defaulted on its subcontracts under way. This issue is becoming increasingly more frequent as baby boomers are leaving the workforce and turning the reins over to the next generation, leaving the company with both financial and managerial gaps to fill.

9. Equipment and real-estate values falling below the loan balances due on the assets. Contractors who financed fixed-asset purchases at the height of the market are being left with loan balances exceeding the depressed value of the equipment. The debt burden can become an insurmountable problem when combined with lower margins and less work, leading good contractors to choose bankruptcy as a way out.

10. Off-balance-sheet activities that drain a contractor's financial resources. Many contractors invest heavily outside the construction business, notably in real-estate development. When there is a need for cash to support those investments, owners often borrow money from the construction company. Given the negative state of the real estate market, the loan may never be repaid, thereby affecting the company's capital base, cash flow and even surety credit.

The construction business is faced with tremendous challenges. However, the best construction companies can look to the future with great confidence, knowing if they receive the right advice from a professional surety-bond producer and a strong surety carrier, they can manage through this difficult environment and emerge stronger as a result.

Mary Jeanne Anderson is president of Hanover Surety, the 10th largest writer of surety bonds in the United States. Hanover Surety is a division of The Hanover Insurance Group, which is "A" rated by A.M. Best and has a treasury limit exceeding $150 million.

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the as-built condition of the project. Resolution of the claim is in the best interest of all three parties—owner, contractor and surety.

In conclusion, by taking steps discussed in this section owners can reduce the risks inherent in private construction contracts. Through the appropriate use of surety bonds, effective communication and cooperation, an owner can increase the probability of a successful project.

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