# 2009 SURETY MARKET REPORT

## VALUE OF SURETY BONDS IN TODAY'S ECONOMIC CLIMATE

As demonstrated by steep declines in the AIA Architectural index and other leading construction indicators, the current economic downturn presents significant risk to the construction industry. In the areas of public and private commercial construction spending, the construction industry is facing its worst slowdown in decades. Growing state and local government deficits and reduced private investment suggest contractors face fewer bid opportunities, increased competition and higher default rates over the next several years. In this environment, the expanded economic risk to owners and subcontractors significantly increases the importance and value of surety bonding as a responsible vehicle to mitigate and manage risk.

# SURETY MARKET REPORT

## CREDIT CRISIS

The negative shifts in credit availability and cost of capital have significantly affected owners' abilities to finance new construction projects. Many projects simply cannot obtain financing based on reasonable terms and conditions.

Most notably, developers of highly visible commercial projects around the country are unable to secure the bank support to get projects moving and in some cases, to sustain projects. "In several markets we have seen large vertical projects stopped during the course of construction," says William A. Marino, chairman and CEO, Allied North America.

Subsequently, many contractors in the private sector have seen a reduction in available project opportunities. This presents a tremendous concern for prime contractors, subcontractors and suppliers. "We would urge anyone performing work in the private sector to thoroughly investigate the funding for the project," advises Michael P. Foster, executive vice president, Merchants Bonding Co. (Mutual). "We have seen funding get pulled after work has begun. We would also suggest attempting to address this potential issue in the contract."

In an environment of uncertainty and increased regulatory oversight, banks have returned to underwriting basics. In addition to restricted credit availability, more banks are imposing commitment fees and requiring personal guarantees when negotiating renewal terms and conditions for credit facilities. This negatively affects both owners and contractors. "Banks are concerned about their own balance sheet and more inclined to look for higher rates of return on all credit products," explains Michael J. Cusack, senior vice president, managing director, and operations board member, Aon Construction Services Group.

The credit crisis has altered contractors' approach to bidding projects. Economic uncertainty has increased the contractor's need to ask more questions of project owners regarding the terms and conditions behind construction loans, as well as asking questions of key subcontractors regarding the availability of credit under working capital credit facilities.

Credit concerns also have extended to contractor borrowing. "There has been a general restriction in available credit to contractors over the last 12 months," observes Thomas Kunkel, chairman of the board, The Surety & Fidelity Association of America (SFAA), and president and CEO, Travelers Bond. "However, well-financed and well-run contractors still have been able to obtain new credit or renew or increase existing lines, especially those that have maintained a productive and transparent long-term relationship with the right banks."

Looking forward, there is concern going into 2009 and 2010 whether banks will renew contractors' lines of credit. And if so, will they receive the same terms or will the line be reduced? Many contractors are pursuing contingent banking relationships just in case.

Particularly in view of the credit crisis, banks are becoming more concerned about issuing credit, and some surety executives have noticed a significant increase in the use of bonds on private work. "As bankers have been faced with their own credit issues, they are wisely looking to surety bonds as a way to protect their investment in a project as much as possible," SFAA's Kunkel notes.

"Bankers are working hard to strengthen their lending criteria and they recognize the value that surety brings to the equation," adds Dan Riordan, president, Zurich North America Surety, Credit and Political Risk. "All of us benefit from this approach, and we need to continue to do our job every day and continue to earn that trust."

Unlike banks which have experienced credit problems, P&C insurers are fundamentally sound and haven't required any government bailout. Surety credit remains strong and available.

## PUBLIC AND COMMERCIAL CONSTRUCTION

Although the recession is broadly affecting the nation, the impact is regional. The previously overheated regions of Las Vegas, southern California, south Florida, Arizona and Atlantic City have seen substantial reductions in new construction. Moreover, auto industry-related problems also have negatively affected construction spending in the upper Midwest, particularly in Michigan, northern Ohio and northern Indiana.

The regions of the country that are experiencing the greatest level of pain may be those where there were very aggressive levels of residential development. As these markets have slowed down, those contractors that historically worked in the private sector are now looking to replace their private backlogs with projects from the public sector.

While somewhat more resilient, the northeast corridor—from Boston to Washington, D.C.—also is experiencing a slowdown. Within the negative statistics, only a few states such as Texas, Oklahoma and Louisiana appear to be modestly impacted as considerable storm and hurricane rebuilding from federal and other funding benefits these states.

Overall, the entire country has experienced a decline in construction investment. The U.S. Census reported that the seasonally adjusted annual rate of nonresidential construction put in place grew 2.5% in April 2009 over April 2008. "Contractors must remain in front of the economic curve and continually right-size their business in a declining construction marketplace," Aon's Cusack says.

Many surety executives expect the stimulus plan to positively affect many regions, especially those that stand to obtain the most money

**TOP 10 WRITERS OF SURETY BONDS—2008***

| | Companies | Direct Premium Written (Millions $) |
|---|---|---|
| 1. | Travelers Bond | $991.6 |
| 2. | Liberty Mutual Insurance Group | $832.8 |
| 3. | Zurich Insurance Group | $482.3 |
| 4. | CNA Insurance Group | $434.3 |
| 5. | Chubb & Son Inc. Group | $297.3 |
| 6. | Hartford Fire & Casualty Group | $210.6 |
| 7. | HCC Surety Group | $148.8 |
| 8. | International Fidelity Insurance Co. | $118.8 |
| 9. | ACE Ltd. Group | $109.1 |
| 10. | Arch Capital Group | $105.9 |

*Includes contract and commercial surety

*Source: The Surety & Fidelity Association of America (SFAA), "Top 100 Writers of Surety Bonds—United States & Territories & Canada," 2008 (Preliminary); www.surety.org* for infrastructure work. Predicting when nonresidential construction will rebound, however, is difficult. Some surety executives say it will depend on a host of circumstances including the Federal Reserve's handling of interest rates, the general state of the economy, and how well the stimulus package works. Most say it is likely that the overall private market won't return until the second or third quarter of 2010.

## PROFIT MARGINS

Contractors' profit margins continue to decline because of economic conditions and increased competition. Many projects in all lines of construction are experiencing an extremely large number of bidders. "I have seen more requests from prospective clients in the private sector to set up bonding lines for public work this year than in any other year I have been in the surety business," relates Todd Loehnert, president, National Association of Surety Bond Producers (NASBP), and senior vice president and bond manager, Wells Fargo Insurance Services of Kentucky Inc. "The private sector is drying up, and these contractors are entering the public bid market."

Surety executives say that noticeable improvement in margins is unlikely until the middle of 2011. "How effectively the contractor is able to respond to these market conditions will determine its long-term success or failure," says Doug Hinkle, chief underwriting officer, CNA Surety.

Many contractors had good backlogs going into 2008 and carried profitable work most of the year. "Most contractors' crystal ball for 2009 contained work in the first two or three quarters and then it was anyone's guess for 2010," NASBP's Loehnert adds.

The backlogs for larger contractors appear adequate to allow firms to remain profitable through the first half of 2010. Absent new work, middle market companies will see backlogs begin to wind down in the fourth quarter of 2009. Subcontractors already are experiencing shortages of work and will have dangerously low backlogs beginning in the second half of 2009. "Presently, contractors appear unable to replenish the backlog with like-kind work, either because of the extensive competition for new construction jobs or because projects are being put on hold and pulled from bid openings," says Mark C. Vonnahme, executive vice president, surety, Arch Insurance Group Inc.

Based on bidding trends described by surety executives, only the larger contractors that are engaged in longer term projects have any backlog that extends well into 2010 and 2011. Middle-market builders and subcontractors, executives suggest, will be substantially out of work sometime between the end of 2009 and the first half of 2010.

## AVOIDING DEFAULT

Surety professionals play an extremely important role in the success of a contractor's business. "Sureties have the ability to trend contractors against sector peer groups to help the contractor determine what cash liquidity and net worth position relative to backlogs will best optimize their ability to succeed in both up and down cycles," explains Rod Williams, chief underwriting officer, Liberty Mutual Surety.

Surety professionals also provide valuable input to contractors regarding maintaining core capabilities during a down cycle. Contractors need to retain top personnel—including successful project managers—as well as critical equipment. They are advised to avoid taking on unfamiliar work or in unfamiliar areas. Even though a contractor's area may be suffering, many surety executives say it is better to suffer effects of less work than to venture into new work or a new region.

Project owners should make sure the contractor has all of the proper insurance and bonding in place prior to the beginning of construction.

To summarize a few key things that project owners can do to help avoid default:

1. Provide a contract that is fair and with clear terms, conditions and owner and contractor obligations. A clear definition of default should be included.
2. Provide quality plans and specifications. "An inordinate number of change orders dealing with bad plans generally results in a difficult project for both owner and contractor," CNA's Hinkle explains.
3. Pay the contractor in accordance to the time frame established in the contract. "Slow pay creates problems," he says.
4. Keep the surety apprised of any potential issues.

## SURETY MARKET FORECAST

Despite significantly reduced surety premium and expected increased losses, the surety industry as a whole should be profitable in 2009. Surety executives say, however, it is difficult to see how the surety industry could perform at the same levels as it has over the last few years. "Surety company performances will vary," SFAA's Kunkel says, "but on the whole, we expect the current scenario to lead to increased industry losses and a tightening of available credit."

The surety industry may be in for some rough times in 2010 and beyond but is ready to meet the challenge. Tim Mikolajewski, president, Liberty Mutual Surety, notes, "Unlike banks, property and casualty insurers are financially fundamentally sound. Recognizing surety is a long-term, highly volatile product line, most prudent sureties are conservatively reserved and exercised disciplined underwriting that should mitigate the impact of the current downturn."

Executives have begun to see some claims activity involving small contractors and subcontractors toward the end of 2008 and beginning of 2009. They expect defaults to increase later in 2009 and anticipate some middle market contractors to be affected in 2010 and 2011. "These will be tough years," notes Henry W. Nozko Jr., president, ACSTAR Insurance Co.

Contractor defaults translate into surety losses, and 2009 may prove to be a transition year where the combination of slower growth in public spending, greater competition and the increased number of residential and private sector contractors bidding public work will lead to increased loss activity for sureties. Surety executives expect contractors to begin to bid work beyond their experience level as the recession continues and they are unable to secure more familiar work. "Also, contractors may migrate away from their more familiar territories for the same reason," Arch's Vonnahme notes. "Balance sheets may be overstated with uncollectible receivables from owners who were unable or unwilling to pay for change order work."


BILL MARINO
Chairman & CEO
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Surety executives also anticipate increases in both surety claim frequency and severity. “We don’t believe ratios will reach the cataclysmal ratios of 2001-03,” ACSTAR’s Nozko says. “We expect a change for the worse, but underwriting has remained disciplined. Sureties will be hit by the economy, but not as severely.”

Most surety executives are confident there is more than sufficient bonding capacity for every level of qualified contractor—from small to jumbo. “Sureties see what is happening in the construction economy and want to support the client base and protect their revenue stream,” Zurich’s Riordan says.

Executives have not seen the current economic environment result in surety companies materially adjusting the level of support that they are willing to extend to all clients. “What we have been seeing are sureties responding to the changing composition of their clients’ balance sheets and adjusting program commitments as necessary,” Allied’s Marino says.

## VALUE OF SURETY BONDING

While surety executives aren’t seeing much private construction work, what private work they are seeing increasingly has a bond requirement. “Bonding in the private sector may become a norm for some time,” ACSTAR’s Nozko suggests. “There are a lot of contractors that lived on private work and didn’t do any public work, and now these contractors are going to face having to qualify for a bond. Customers won’t get the job without a bond.”

Owners are concerned about the general contractor’s ability to meet the obligations of their contracts, and general contractors have the same concerns relative to their subcontractors. “We have seen a very definite trend where owners and general contractors that had not historically purchased bonds are now requiring them to support issued contracts,” Allied’s Marino says.

Merchants’ Foster adds, “We are seeing more general contractors requiring subcontract bonds in order to mitigate their risk. Sophisticated general contractors understand that the next two years will be difficult for many subcontractors.”

In today’s challenging economic climate, the rigorous prequalification process, assurance of project completion and protection against contractor default make surety bonding a highly attractive, yet affordable, risk mitigation tool for project owners and their investors, stakeholders and lenders. Project owners can be further assured that the bonded contractors on their construction projects have experienced construction advisers—the surety agent and underwriter—behind them to provide guidance, resources and expert advice to help their clients avoid unnecessary risk and pitfalls that can lead to contractor default.

Given that contractors are facing fewer job opportunities, a restriction in bank credit availability, declining profit margins, reduced backlogs and are operating leaner than during the robust years of 2004 to 2008, surety executives anticipate that default may be unavoidable for some contractors. “The value that sureties bring in terms of expertise, risk management and supporting qualified contractors to bid and perform work is a valued service to owners, contractors and the U.S. economy,” Zurich’s Riordan says.

Sureties will continue to play an ever-increasing role in the marketplace in 2010 and beyond. Financial scandals and the credit crisis have proven the value that surety brings to owners by supporting qualified contractors to build infrastructure and other projects that help the U.S. economy grow and prosper.

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

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The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

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The National Association of Surety Bond Producers (NASBP) is the association of and resource for surety bond producers. NASBP members are professionals who specialize in providing surety bonds for construction and other commercial purposes to companies and individuals needing the assurance offered by surety bonds. NASBP members have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.

# SURETY MARKET REPORT

## EXECUTIVE PERSPECTIVES

*Thomas Kunkel*
*Chair, The Surety & Fidelity Association of America (SFAA)*
*President and CEO, Travelers Bond*

*Terry Lukow*
*Executive Vice President*
*Travelers Bond, Construction Services*

There is inherent risk in the construction business—in good times and bad. Prudent owners and their financing sources should always insist on surety bonding as a primary risk management mechanism.

Prequalification and the protection provided by surety bonding are more important than ever. Individual contractors have experienced the economic downturn in a variety of ways. The evolution has been rapid and uneven. It is very difficult for any owner or lender to truly appraise the underlying financial impact and current risk profile of a given contractor. Sureties specialize in this. All things considered, it is truly an inexpensive way to significantly mitigate risk.

Considering general economic conditions and the very low contractor default rates the industry has experienced over the last several months, it is logical to expect industry default rates to increase in 2009 and 2010. Industry results in 2011 will depend on how deep and prolonged the country's economic issues persist.

We have prepared our clients for the downturn by trying to be good business "partners" in the true sense of the word. This entails having frank discussions on business plans and best practices, along with challenging one another to not accept the status quo. This always involves striving to improve during the good times, so that contractors are well-positioned during the down times.

*Todd Loehnert*
*President, National Association of Surety Bond Producers (NASBP)*
*Senior Vice President, Bond Manager, Wells Fargo Insurance Services of Kentucky Inc.*

Failure to require bonds subjects the private owner, developer, investor and/or lender, if applicable, to unnecessary and unwarranted financial risk, which could jeopardize the viability of subcontractors and suppliers if the contractor becomes insolvent or fails to pay its obligations.

An owner should know that his or her project might not be the cause of the contractor's default and/or problems. Although the owner might think that he or she can monitor the contractor's performance on their project, more than likely, the contractor will have other projects ongoing that the owner has no control over. Problems on any of the other projects easily could affect the owner's project.

The prequalification that sureties perform for bonded work is, and always has been, important in protecting the risk to the owner. On public work it protects the taxpayer, and on private work it protects the lender.

Surety prequalification is more important now in the private sector. The private sector has a built-in element of assumed risk. Given our current economic situation, owners in the private sector see surety bonds as a good decision in protecting their investment. I am currently seeing an increase in private sector bonding requirements. I also am seeing municipalities and public obligees placing subcontract bond requirements into bid specs to protect themselves and the general contractor and/or CM at Risk from subcontractor default.

*Timothy Mikolajewski*
*President*

*Rod Williams*
*Executive Vice President*
*Chief Underwriting Officer*
*Liberty Mutual Surety*

Today's construction slowdown has increased risk for contractors and owners alike. In this environment, surety bonds represent an important risk management tool for owners to manage construction risk and for contractors to protect against subcontractor or supplier defaults. Despite today's contractors being well-managed and better able to plan for shifts in construction spending, there are clear indications that the current construction downturn is the deepest in years and likely to increase contractor default rates materially in late 2009 and 2010. This risk of increased defaults makes the surety prequalification process and direct communication between owners, agents, contractors and sureties more relevant than ever.

While some bonded contractors may worry about continued surety credit in the down cycle, we believe it is important for a surety to maintain consistent sound underwriting across both up and down economic cycles. At all times, we encourage contractors to build balance sheet strength and liquidity to prepare for slow periods. We also promote responsiveness and transparency in the underwriting process to help contractors plan ahead and quickly adapt to changing market conditions. When a contractor experiences financial instability, our underwriter teams work collaboratively with contractors and agents to develop bonding solutions and business strategies to help get contractors back on track.

Presently, there is ample surety capacity available and as the cycle continues, conservatively reserved and well-capitalized sureties should continue to provide solid capacity. Although some weaker, reinsurance dependent sureties may reevaluate capacity commitments, we remain confident that surety capacity will continue to be available to well-managed, financially sound contractors who value the surety relationship.

*Dan Riordan*
*President*
*Zurich North America Surety, Credit and Political Risk*

The current economic challenges underscore the importance and role of credit in the growth and prosperity of our economy. While surety traditionally is involved in all public work, owners, developers, investors and construction lenders should fully explore the value that surety brings to the table in terms of prequalifying

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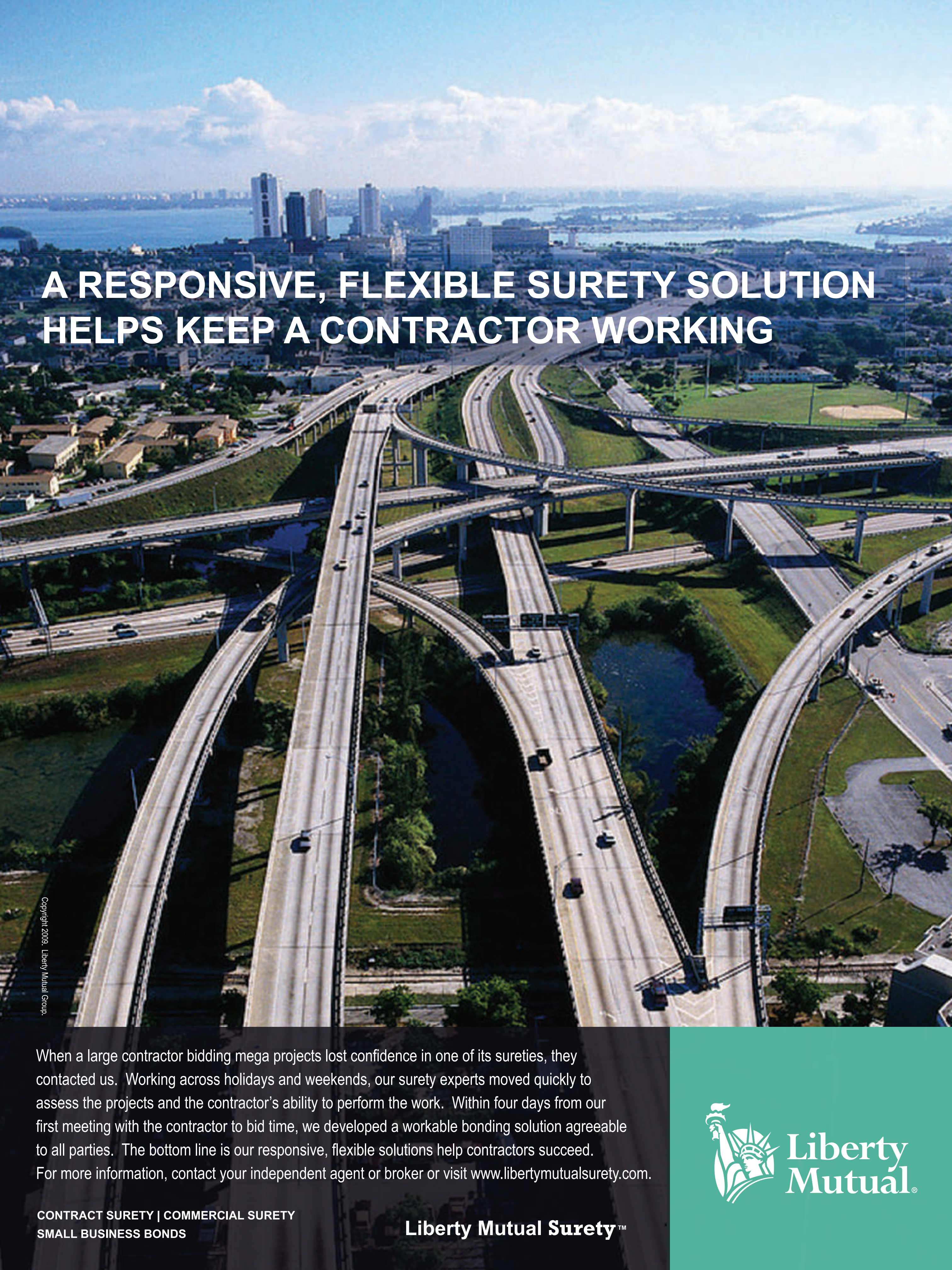
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## EXECUTIVE PERSPECTIVES

contractors, risk management insight and claims expertise for private work as well. The risks facing the construction industry today are greater than ever, and private owners and general contractors need the benefits of surety as much as public owners do.

In the prequalification process the surety gets to know the contractor and that contractor's capabilities, history, performance track record and importantly, that contractor's financial capacity. The full analysis that we perform provides a good understanding of what type of work and projects the contractor will be able to successfully perform. The surety makes an underwriting evaluation to support a contractor and a project, and if we support it, we commit substantial amounts of capital. That capital ultimately provides the assurance of project completion in the event of project default.

The bad news regarding Wall Street excesses, stock-market volatility and the like makes it difficult for the public to maintain a positive approach to business. The surety industry must reinforce the positive contributions we bring to the business environment such as supporting the economic development of our country by helping to rebuild roads, bridges, schools, water and sewer projects and the like. Surety plays a vital role in the construction economy in terms of the guarantees we provide for the benefit of owners, developers, contractors and subcontractors and others.

*Doug Hinkle*
*Chief Underwriting Officer*
*CNA Surety*

Given the current broad-based U.S. economic issues and their impact on the construction industry, there would not be a more prudent time than now to require bonding on any private project.

Contractors in general are facing less work opportunities, increased competition that puts downward pressure on margins and owners that are slow to pay. Contractors need to wisely manage and structure their business to effectively adapt to a deteriorating business environment. These market characteristics will test contractor management capability. As in all recessionary cycles, some firms will not survive.

Requesting a bond on a private project is the most effective approach in assuring that a project will be built in accordance to the plans and specs and that labor and material costs are paid. Requiring a bond is always an effective risk management tool, but in these uncertain times, it is a particularly good investment.

Because of the extensive coverage provided in a performance and payment bond, the surety must perform a thorough analysis of all aspects of the contractor's business. The analysis includes ongoing financial review to ensure necessary financial strength; a capacity review to validate the expertise, equipment and manpower to perform the work; and affirmation relative to the character of the business owners—an essential ingredient to the long-term success of a business.

In the event this analysis is proven wrong, the surety bond stands ready with its guarantees of both project performance and payment of labor and material.

*Mark C. Vonnahme*
*Executive Vice President, Surety*
*Arch Insurance Group Inc.*

Surety prequalification is more important today, and in uncertain economic times, than when the economy is expanding. Everyone is concerned about investing their money and making sure that risks are managed in the process. Suretyship is one of those ways you as an owner, lender or investor can find protection for the investment you are committing to the construction industry. Sureties have the knowledge base in financial analysis and other credit extension skills to at least give you the assurance that the project will be completed in accordance with the terms and conditions of the contract and that the subs and suppliers are paid.

If we have learned anything from the adjustments in the financial markets, it should be that certain basic relationships are important. Profit. cash, low debt, managing overhead and other costs and a strong organization are important for success. Surety is one of those basic relationships that may be forgotten when the economy is expanding. Surety provides a tested model for managing the risks of construction failure for an owner or lender on private construction.

It is also a time for the relationship between contractors and sureties to be nurtured and developed. Not every year will be successful in the lifetime of a contractor. Sureties understand that. They know they need to be supportive of a contractor's operation even when times are tight and challenging. Therefore, the communication process between contractor and surety, in concert with their broker, is an imperative to success in these challenging economic times.

*William A. Marino*
*Chairman and CEO*
*Allied North America*

Transferring construction risk through the procurement of performance and payment bonds is a practice that has served the construction industry well for decades. It is imperative that when purchasing a bond, the obligee underwrites the quality of the surety supporting the instrument and that the carrier has a sufficient claims department to be able to meet the complexities associated with handling a default.

We expect to see contractor default rates that vary significantly by regions of the country. In areas where there have been significant declines in the levels of residential construction, firms transitioning from private to public work have placed significant pressure on project pricing.

There are several actions that can be taken by an owner that will have a positive impact on the magnitude of an economic loss in the event of a contractor default. The first action that can be taken is to make sure that you are comfortable with the schedule of values and that the contractor is not being paid for work that has not been completed. Owners also should do whatever is necessary

## EXECUTIVE PERSPECTIVES

to assure that work is being completed in accordance with the plans and specifications. Remedial work is often one of the largest expenses associated with a contractor default. Making sure the project is adequately staffed to meet the established schedule also is important, as an often understaffed project is indicative of a contractor that is experiencing financial difficulties. Information relative to the contractor's meeting his or her financial obligations to material suppliers and subcontractors should be collected and appropriately verified.

*Henry W. Nozko Jr.*
*President*
*ACSTAR Insurance Co.*

Requiring a bond is a way to assure project completion. Owners should remember that since 1995, sureties have paid out about $10.5 billion in losses that owners would have had to pay had sureties not covered them.

Project owners should be leery of unusually low bids. Owners can reduce the risk of contractor default by avoiding the temptation to engage the contractor that sticks out like a sore thumb with a low price. This is usually a sign of something wrong.

Owners should do some of their own due diligence. Find out what the contractor's workload and backlog is, ask for current financial statements to see how they are performing and be more diligent in the selection process. Owners also should be very careful in selecting their designers and careful about the contract terms with their designers. For example, liability should not be limited to the amount of the fee.

When default does occur, complete cooperation with the surety will make the transition smoother. It's a difficult process, but the owner certainly can minimize problems of a default by cooperating with the surety and providing all information the owner has available. Early notice to a surety also is helpful.

Sometimes the surety isn't notified until the contractor has stopped working. If the surety is familiar with the issues, it can be proactive and may help avoid a default by getting involved. The surety can be a great mediation source between a contractor and an owner.

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

There has been some evidence of increased contractor failures involving smaller firms and subcontractors already in 2009. This increasing trend of smaller contractor defaults will accelerate through the end of 2009. The failure rate of middle market firms will become more noticeable beginning in the second half of 2010, and we project that the industry will experience a few larger middle market contractor defaults by the end of the second quarter 2010.

With the risk of contractor default being more prevalent, the performance and payment guarantees provided by sureties will separate the firms that can get the job done from the companies that are experiencing difficulty proactively managing their business. In this unstable economic environment, owners that proceed with their projects without surety prequalification will be assuming the risk that their contractors are running their businesses efficiently, have sufficient backlog or loss absorption capability to endure this economy, have a healthy relationship with their bank and are meeting obligations to subcontractors and vendors.

Surety underwriters draw upon years of experience in measuring a contracting company's capabilities. The underwriting analysis includes a review of financial matters, the organization's experience, business succession planning, a company's relationship with owners and subcontractors, as well as the type and size of construction that will be performed. Even with these comprehensive underwriting reviews, the dynamic nature of the construction marketplace always creates challenges that can push contractors to the brink of failure.

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

Most of our accounts feel good about 2009 but are concerned beyond that. They are attempting to replace their current backlog. Many of our accounts are telling us that they need additional work or they will have to consider laying off good people. However, margins are thin on this work due to the large number of bidders. We do not anticipate seeing a recovery in the private construction market until 2011.

It has never been more important for contractors to demonstrate good business judgment, in addition to being a good contractor. Contractors should rely on their team of professionals to help them achieve their goals and make sure their team is fully aware of what their goals are. It is essential that their agent, accountant, banker, lawyer and surety underwriter are working together for their benefit. Some of these value-added services include review of contact language, bond forms and insurance requirements. We live in a world of risk avoidance. Contractors need to fully understand the potential risk involved in signing a contract, and make a business decision accordingly. The team of professionals should be able to provide the contractor with assistance on continuity and estate planning. They are there to help the contractor succeed, and the contractor should take advantage of this. Also, I cannot stress how important communication is. Contractors should meet with their underwriter on a regular basis, not just when there are problems.

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CNA SURETY

# BEWARE OF INADEQUATE OR FRAUDULENT SURETY BONDS

*By Edward G. Gallagher, The Surety & Fidelity Association of America (SFAA) and Mark H. McCallum, National Association of Surety Bond Producers (NASBP)*

A surety bond is only as good as the surety issuing it. A surety that is not itself financially sound cannot add to the credit standing of its principal. Surety is regulated as a type of insurance, and to some extent an owner, contractor or subcontractor can depend on the state insurance departments and the United States Department of the Treasury to perform financial due diligence. There are also several private organizations, most prominently A.M. Best Company, that issue financial ratings of insurers. Although the bond is normally legitimate, a prudent owner, contractor or subcontractor should take steps to assure that the bond will, in fact, provide the promised protection.

## CORPORATE SURETIES

Regulated insurance companies write the vast majority of surety bonds. Contractors and subcontractors should check with the insurance department of the state where the bond is issued to verify that the surety company is authorized to write surety bonds. Surety companies wishing to write Miller Act bonds on federal construction projects must possess a certificate of authority from the U.S. Dept. of the Treasury. A list of surety companies approved to write bonds to the U.S., Department Circular 570, is available at www.fms.treas.gov/c570/c570_a-z.html. The name of the surety and the name of the insurance company should be an exact match. There are instances in which unlicensed entities used a name that was very similar to a legitimate surety company.

The fact that the surety company is genuine and solvent is not sufficient if the company did not authorize the bond. The easiest way to confirm that the bond was authorized is to contact the surety directly. Treasury Dept. Circular 570 includes the telephone number of the Treasury Listed sureties, and The Surety & Fidelity Association of America's website has a Bond Obligee's Guide that identifies whom to contact to verify bonds issued by its members.

The danger of relying on just the name of a legitimate surety is illustrated by a recent criminal case in the United States District Court for the Middle District of Florida in which a Maryland resident, William Raymond Miller, pled guilty to mail and wire fraud in furnishing fraudulent bonds that purported to be issued by legitimate sureties. The Dept. of Justice Press Release of December 11, 2008, describing the guilty plea stated, "On numerous occasions, Miller made it appear that he was issuing bonds in the names of legitimate insurers… Miller issued surety bonds with a face value of over $535 million and received premium payments of over $22.5 million during the course of the fraud." (http://jacksonville.fbi.gov/dojpressrel/pressrel08/bondfraud121108.htm).

## INDIVIDUAL OR PERSONAL SURETIES

There is a long history of fraud by individuals claiming to act as sureties on construction contract bonds. For state or private projects, surety is regulated by the states as a type of insurance. Unfortunately, state insurance departments have typically enforced their laws by issuing cease and desist orders, which have not proven to be effective in preventing abuse. See, for example, http://www.dora.state.co.us/Insurance/enforcement/2007/O07-065.pdf (ABBA Bonding/Morris C. Sears) and http://www.insurance.wa.gov/oicfiles/orders/2004orders/D04-189.pdf (Global Bonding/Robert Joe Hanson).

The U.S. will accept individual surety bonds on federal government construction projects if certain stringent requirements are met. The surety must place cash or cash equivalents equal to the amount of the bonds in escrow with a federally insured financial institution or provide the government with a deed of trust on real property to secure the bond. See Federal Acquisition Regulations (FAR) §28.203, et seq. (48 C.F.R. §§28.203 et seq.).

Prior to amendments effective on February 26, 1990, the FAR permitted acceptance of individual sureties based on a sworn statement from the surety that his or her net worth was sufficient to cover the bond obligations. In many instances, this sworn statement was found to be false and the assets illusory. The FAR amendments required the deposit of cash or cash equivalents, and excluded various types of assets that fraudulent individual sureties often claimed on their sworn statements. The change was comparable to a bank stopping unsecured lending based on the borrower's representations and instituting secured lending based on a security interest in specific, verified assets.

There is no central authority, such as the U.S. Dept. of the Treasury, to vet proposed individual surety bonds. The contracting officer has to evaluate them during the course of a particular procurement. This places a significant administrative burden on federal contracting officers who possess differing levels of knowledge regarding surety bonds and the kinds of assets required to back individual surety bonds under the FAR. Contracting officers are sometimes fooled by artfully crafted submissions that appear impressive but have no substance. See, U.S. Dept. of Treasury, Financial Management Service, "Special Informational Notice to All Bond-Approving (Contracting) Officers," dated February 3, 2006, at http://fms.treas.gov/c570/special_notice.pdf.

An owner or prime contractor tendered a bid or performance bond, or a subcontractor or supplier asked to provide labor or material in reliance on a payment bond, should not assume that someone else has done its due diligence. Anyone relying on a bond should obtain a copy and verify that there is a legitimate surety that will be financially responsible. If the surety is not a regulated insurer, the assets pledged to back the bond should be verified. An attorney can help check on any criminal record, bankruptcies, or cease and desist orders issued against the purported surety.

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SURETY
MARKET REPORT

# ARRA PACKAGE CHALLENGES SMALL CONTRACTORS

*By Surety & Fidelity Association of America*

The Asset Recovery and Reinvestment Act (ARRA), the economic stimulus package that Congress enacted early this year, contains several provisions that have a direct impact on access to bonding for small and emerging contractors.

The economic stimulus package's investment in improving and modernizing the nation's infrastructure will provide contracting opportunities to general contractors and subcontractors, many of whom are small. In a targeted effort to accelerate small contractor participation, the legislation provides an additional $15 million in funding for SBA's Surety Bond Guarantee Program and increases the ceiling for bond guarantees from $2 million to $5 million. It also has provided $20 million in additional funding to the U.S. Dept. of Transportation's Office of Small and Disadvantaged Business Utilization.

These resources to SBA and DOT are welcome and should help small contractors obtain some of this stimulus work. Yet, the current economic downturn has led to larger construction companies bidding on smaller jobs that, under better market conditions, would have been left mostly to small contractors. This shift is coming when small contractors are exiting residential construction and seeking public jobs for the first time. Competition for small contractors will be tougher and SBA and DOT resources are needed more than ever.

A number of issues need to be resolved regarding the SBA program. The Surety & Fidelity Association of America (SFAA) and National Association of Surety Bond Producers (NASBP) have been working with SBA to restructure the program to make it more attractive to surety companies and agents and help more contractors take advantage of these bond guarantees.

SFAA also is helping to redesign a DOT bond guarantee program to more effectively serve DBEs involved in transportation projects by adapting it to SFAA's Model Contractor Development Program, which contains educational and bond readiness components to enhance the business capabilities of small and emerging contractors and better position them to bid on transportation-related projects. The SBA, DOT and other existing bond guarantee programs are all the more important in today's current economic downturn, as more and more contractors seek bonding assistance.

# THE GOVERNMENT STIMULUS PACKAGE AND ITS IMPACT ON BONDING

*By David Hewett, Zurich Surety, Credit & Political Risk*

John Maynard Keynes said, "To dig holes in the ground, paid for out of savings, will increase, not only employment, but the real national dividend of useful goods and services." In today's tumultuous market, Keynesian economic theory is once again being put in practice to help stimulate the economy. Fortunately, the construction business is one area that will receive support in these uncertain times. This action has brought focus to the impact of the American Recovery and Reinvestment Act (ARRA) on the construction industry. Considering their close relationship to the construction industry, sureties must make sure they understand the impact of ARRA on their clients.

The figures associated with ARRA are well known at this point, with an estimated $130 billion available in construction funding. This spending could not come at a better time for both owners letting the work and contractors acquiring the same. Some key sectors seeing spending from ARRA are:

- Transportation infrastructure at $49.3 billion
- Water and environmental at $21.4 billion,
- Building at $29.6 billion and
- Energy at $29.8 billion.

Many contractors came into 2009 with strong, but declining, backlogs. This decline continued through a slow first quarter of construction starts. These smaller backlogs, in conjunction with lower commodity pricing, already are leading to deflation in construction. Owners are now beginning to obtain work on better pricing terms than available during the hot construction economy of recent years. While work released in the first quarter was limited, overall it was bargain priced for owners.

During these times, sureties will keep greater watch on the downward pressure on contractor profit margins. The concern is that profitability and financial strength earned by construction companies through the last cycle will begin to erode. With already long bid lists, sureties are beginning to watch backlog profitability.

At the same time, sureties remain bullish on the projected positive impact of the ARRA in relieving some of this pressure. As new work comes out and enters the construction industry, contractor backlogs will improve and begin to relieve some of the current marketplace stress.

The surety industry is positioned well to help customers respond to the stimulus package. The industry is coming off six years of strong profitability. In addition, while poor credit practices and lack of rigor have had a negative impact on the banking industry, the overall underwriting discipline that the surety industry has maintained through this last cycle puts surety companies in a position of strength. While parts of the insurance industry have seen an impact to their balance sheets from bad investments, there has been little impact to most of the Top 10 surety companies.

As a construction company views all the potential positive opportunities coming out of ARRA, how do they work with their surety provider to maximize these opportunities? The first step is a good open dialogue with your broker and surety company. This should begin with:

- A business plan built around the opportunities supported by ARRA.
- A highlight of a company's record of accomplishments in this sector in the federal section.
  - With the decline in commercial construction, more commercial construction firms are looking to branch out into federal work to take advantage of the ARRA money. Federal work has unique requirements; a good risk mitigation strategy should be in place as this expansion is planned. For example, this may include new strategies such as joint venture work with a company that has good experience with the federal agency letting the work.
- A detailed plan on how a firm's backlog will be executed.
  - If the ARRA work comes at a high velocity, it may cause a spike in backlog for construction companies obtaining this work. With the state of the current construction market, we anticipate this would be a temporary spike for most firms. This will give their surety good understanding of how long the increased capacity will be needed.

The U.S. is in far better shape than the last time Keynesian economics ruled the day. Moreover, as a major driver of the overall economy, construction companies are one of the beneficiaries of the government's focus on quick job growth. They are well positioned to take advantage of this opportunity. Moreover, the surety industry sits ready to provide the support needed to both help their clients better understand new perils, as well as provide the capacity they will need to perform this work.

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