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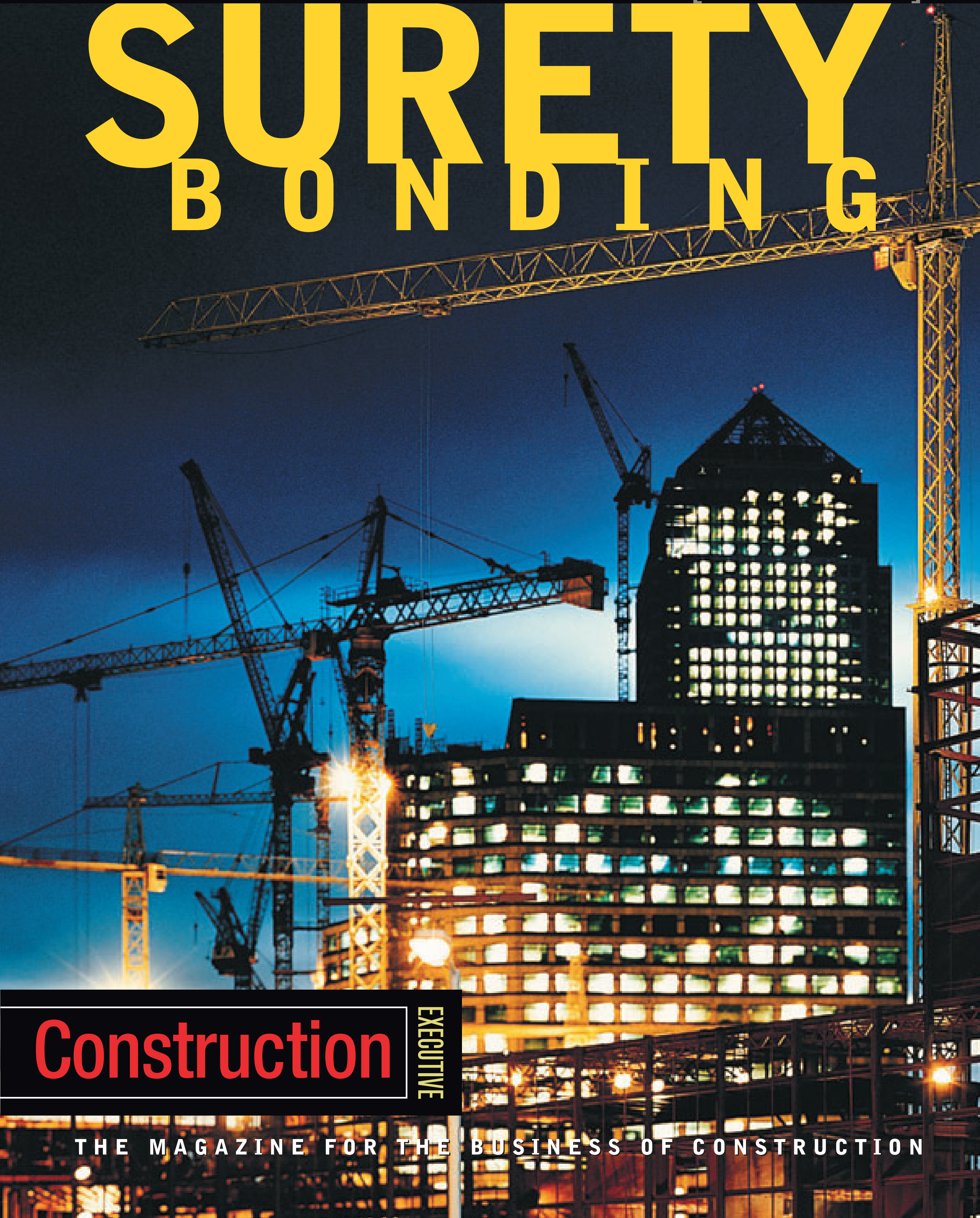
SURETY BONDING



Construction EXECUTIVE

THE MAGAZINE FOR THE BUSINESS OF CONSTRUCTION

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EXCELLING IN TODAY'S SURETY BOND MARKET

BY JASON HUNTSMAN

Times and the surety market have changed. But how do these changes affect contractors? The nation's top surety professionals talk about the state of the surety industry and offer advice to contractors on what to expect and how to thrive in today's market.

HOW DID WE GET HERE?

While the surety industry has gone through a number of changes in recent years, numerous signs indicate that stability is returning to the market. However, today's market does have many unique features, which savvy contractors need to understand fully in order to gain a competitive advantage.

The surety industry faced a number of large losses beginning in 2001, and while commercial surety was especially hard hit, contract surety also experienced substantial losses. Surety companies, like any other businesses, need to remain profitable; as such, the industry has had to reevaluate risks, contend with mergers and adjust pricing structures. Reinsurance companies, which take on a good deal of risk on behalf of sureties, also have had an effect on the industry as they renegotiate their reinsurance treaties.

William E. Cheatham, president of Zurich North America Surety, explains how the surety market changed in recent years.

"Two years ago the surety industry was divided along the lines of national or regional companies. Due to changes and mergers, that line has shifted to serving large, middle or small-sized contracting firms. A few companies are now vying for the large-sized accounts, while the rest of the industry is focused on the middle and small market."

Reinsurers' appetite and ability to help surety companies manage risk are important factors that can affect contractors that receive surety credit.

According to James E. Lee, president of Old Republic Surety Company and chair of the board of directors of The Surety Association of America, "There was some concern as to how much reinsurance capacity would be available to sureties. Thankfully, the void left by reinsurers that have merged or left the market has been partially filled, which in turn has enhanced capacity."

AVAILABILITY OF BONDS

So, is there enough capacity to go around? The answer is yes for qualified and capable firms.

According to Michael Cusack, senior vice president and regional surety director with Aon Construction Services Group, "Due to the contraction of the reinsurance market, capacity is still an issue for large contractors that need surety programs in excess of $250 million. The majority of contractors that have larger work programs will require the support of two or more sureties in the form of a co-surety facility."

While mega-contractors may contend with co-surety arrangements, middle and small-sized firms will most likely be unaffected by capacity issues.

Mike Peters, president of Safeco Surety, elaborates, "There does appear to be good competition and sufficient capacity available for contractors in both of these segments [middle and small-sized firms]. So, for the most part, successful, established contractors should not see capacity issues. Likewise, there will continue to be capacity available to the emerging and small contractor markets, but with more stringent underwriting standards as loss frequency in this market will continue to be a concern."

Geoffrey Haver, senior vice president and construction practice leader with Riggs, Counselman, Michaels & Downes, an Assurex Global Partner, adds, "There is plenty of capacity for small and mid-sized contractors. Minority contractors also have programs available from the Small Business Administration, local initiatives, and the Surety Association of America to strengthen business practices that work toward establishing a bonding program."

PREQUALIFICATION NEEDS

More than ever, sureties need accurate and timely information from contractors in order to manage individual bonding programs. This financial information is not sought for the sake of wanting more paperwork; it is vital for sureties to develop a solid, well-rounded understanding of a contractor's complete business operation.

According to Phil Tobey, vice president of surety with The Dale Group, "For small and emerging contractors seeking their first bond, a three-pronged approach is best. First, they should capitalize their business as best as they can. It's important to have as much money invested in the company as possible and have it documented by a CPA. Second, prepare and provide a resumé that contains detailed project experience. A contractor who has only done $200,000 projects should not expect to move right into half million-dollar projects without the prior experience. Third, don't be too aggressive. Look to build a relationship with a surety and don't expect unrealistic amounts of credit to be extended."

Dennis Perler, president of Liberty Mutual Surety, suggests that the emerging or small contractor who is seeking to move into public-bid projects do so with a balanced, steady approach. It is worthwhile to maintain some private work and not jump headfirst into the public arena, which has a unique set of demands and features that a private-construction firm may be unprepared to manage.

Aon's Cusack explains, "In response to the industry's poor results of the past five years, the implementation of higher underwriting standards was well underway prior to the start of 2004. These standards mandate that contractors commit to putting more capital at risk, retain profits, manage their business based on more restrictive work programs and provide the surety with a consistent flow of high-quality information."

So, what does the surety really want? Accurate, timely and clear information are themes echoed throughout the industry. Sureties need this information to develop a deeper understanding of a contractor's management team, finances, operations and risk-management strategies.

According to Henry Nozko, Jr., president of ACSTAR Surety, "Contractors really should submit financial statements quarterly rather than yearly. Accurate work-in-progress forms are also necessary. It is important that all information submitted to the surety be presented in a legible, easy-to-access manner. Because the volume of paperwork is being handled by fewer surety companies, high-quality, easy-to-understand presentations are essential."

Craig Hansen, senior vice president with Holmes Murphy & Associates, Inc. and president of the National Association of Surety Bond Producers, agrees. "The quality and frequency of underwriting information continues to remain a key to a contractor's success in maximizing the support of their surety underwriter. The surety's understanding of the contractor's business plan is critical to the surety relationship. Working with a professional surety bond producer will enhance a contractor's understanding of current market conditions, and will provide guidance in communicating a contractor's business plan to the surety underwriter," he adds.

The emerging and small contracting firm seeking to start a bonding program may be placed under more scrutiny than an established contractor. However, steps can be taken to make such a business more attractive to a surety.

THE SURETY RELATIONSHIP

Having a solid surety relationship is important during normal conditions, and invaluable during times of uncertainty and change. Open, honest and frequent communication among the contractor, surety bond producer and surety underwriter helps ensure this relationship remains healthy.

"The surety relationship should be treated similarly to other credit relationships. A solid working relationship with a surety company enhances many firms' ability to penetrate markets that fit their strategic plans. Understanding the strengths and limitations of your surety is also important because many surety companies target specific types and sizes of businesses; it is best that your risk profile is in line with the appetite of the surety," says John Welch, president and chief executive officer of CNA Surety.

Sureties, like other businesses that extend credit, have a vested interest in seeing their clients succeed. Because a surety is vouching for a contractor's performance and backing that up with its financial resources, it is imperative that a surety has a clear picture of the principal's company. By regularly communicating with the surety team, contractors can help create a solid business partner for the long haul.

PREMIUMS

Realistically, surety remains an extremely low-priced risk management tool for the 100 percent payment and 100 percent performance protection afforded to an obligee. While many indicate that premiums have stabilized for middle- and small-sized contractors, sureties may continue to adjust pricing for more risk-intensive, large-scale accounts.

Terrence Cavanaugh, chief operating officer with Chubb Surety indicates, "With premiums, there is more of a focus on the risk of the individual project and contractor being taken into consideration. A project that will last four years would be priced differently than one that is scheduled to take one year to complete. Projects that last beyond two years generally have more risk associated with them and will be priced accordingly."

Zurich's Cheatham agrees, "Premiums have leveled off since the pricing restructuring of the past couple of years. However, accounts with high capacity or high-credit risk exposure may have to contend with higher rates. Not all surety companies have imposed realistic rates, but it is important that companies make the surety line attractive to reinsurers and their shareholders."

Writers of Surety

The latter part of the 1990s and the early part of this decade have been a time for change in the surety industry. A number of companies have consolidated or departed from writing the surety line. Looking at the top 10 writers of surety in 2003 compared to 1998 demonstrates how different the industry looks today than it did five years ago. Some of the players may have changed; however, enough surety capacity remains to support the U.S. construction needs.

Top 10 Writers of Surety in the United States—2003

1. Travelers Property Casualty Corp.
2. The St. Paul Companies
3. CNA Insurance Companies
4. Zurich Group
5. Safeco Insurance Companies
6. Chubb Group of Insurance Cos.
7. Liberty Mutual Group
8. The Hartford Insurance Group
9. HICA Holding Group
10. American International Group

© The Surety Association of America, "Fifty Largest Writers of Surety—United States," August 17, 2004. Additional detailed statistical reports are available for purchase at www.surety.org.

Top 10 Writers of Surety in the United States—1998

1. The St. Paul Companies
2. CNA Surety Corporation
3. Reliance Insurance Companies
4. Fidelity & Deposit Group
5. Travelers Property Casualty Corp.
6. American International Group
7. Safeco Insurance Companies
8. Fireman's Fund Insurance Cos.
9. Amwest Insurance Group
10. Frontier Insurance Group, Inc.

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CLAIMS

The word on the street about claims activity is mixed. Some see the more stringent underwriting conditions of the past few years as having a positive effect on claims, while others report that the frequency of claims remains a concern.

While surety bonds typically are underwritten under a zero-loss model, unfortunately claims do occur.

William Marino, chairman and chief executive officer with Allied North America, offers insights into today's claims activity, "The effects of today's back-to-basics underwriting standards won't be realized in the immediate future. While the economy is an important factor on the frequency and severity of claims, the standards employed in the mid to late 1990s are also still having an effect. The frequency and severity of today's claims are due in large part to the more relaxed underwriting standards of the past, not because of today's practices. There is a lag between more thorough underwriting standards and a reduction of claims," Marino says.

"PREMIUMS HAVE LEVELED OFF SINCE THE PRICING RESTRUCTURING OF THE PAST COUPLE OF YEARS. HOWEVER, ACCOUNTS WITH HIGH CAPACITY OR HIGH-CREDIT RISK EXPOSURE MAY HAVE TO CONTEND WITH HIGHER RATES."

According to Safeco's Peters, "There does appear to be more frequency problems than severity problems. Probably the largest trend we've seen with contractors going into a claim is over-expansion either in their work program or in their territory. Usually this was 'promoted' by several years of successful operating results, but somewhat stagnant top-line growth. Obviously growth at the expense of control does not work."

While claims are an unfortunate situation, contractors can take steps in today's market to mitigate loss or even prevent a dispute resulting in an actual claim.

"Construction is a tough business—period. Disputes will happen even to the most solid contractor. However, contractors need to keep thorough documentation and be prepared to share it with their surety when problems arise on a project. Contractors must provide documentation and engage in frequent correspondence with their surety in order to defend their position. A contractor that ignores the surety's calls may be put under more scrutiny," The Dale Group's Tobey says.

An Assurex Global Partner, Riggs, Counselman, Michaels & Downes' Haver offers further advice for supporting contractors' positions and avoiding problematic situations: "Having written documentation is essential for a contractor's position to be preserved. All change orders should be in writing and signed-off by only those who have pre-approved authority. Contractors should enter into standard contract documents such as AIA's and must develop a thorough understanding of any manuscript contract. It's also important to know who you are working for and who's working for you. Bad reputations—both of owners and others potentially working on a project—should be seriously taken into consideration."

LOOKING AHEAD

Eventually the surety market will introduce new players, bringing with it additional capacity and the potential for a softening market. However, many predict this will occur slowly and also foresee today's market conditions and solid underwriting practices remaining in effect for several years to come.

The near future of the surety industry will be met with a cautious optimism. While the industry incurred nearly $1.3 billion in contract surety claims in 2003, according to the Surety Association of America, many foresee the possibility of moderate profitability within the next few years.

The short-term outlook for the surety industry has a great deal to do with the unpredictable nature of the overall economy. While the construction market has shown strong growth in 2004, the effects of rising prices for gasoline, steel, concrete and other construction-related commodities remain important factors for long-term growth. If economic conditions decline for contractors, the domino effect on claims may negatively affect the surety industry's bottom line.

For the near term, construction is strong—according to the U.S. Census Bureau, during the first seven months of 2004, non-residential construction spending amounted to $451.5 billion—5 percent above the $430.1 billion for the same period in 2003.

"Although there has been more of a focus on solid underwriting standards, economic uncertainties are an area for serious concern. Issues such as inflation, a lack of government funding for public works and scarcity of construction materials may coalesce to create a more hostile construction environment than was in place two to three years ago. This is something that may cause problems this year and next," Chubb's Cavanaugh says.

Michael F. Greer, vice president of surety and fidelity with Penn National Insurance, offers a candid view on the outlook for the industry. "The surety industry is currently in the reality stage. Losses in the past couple of years have been frequent and severe, and there are fewer sureties than there used to be.

"We hope sureties follow the same advice that they give to their clients. A consistent, underwriting-based surety company is the one that will be around in both good times and bad. The hot surety company that doesn't ask questions and competes on giving away capacity is just like that hot stock tip from the broker who calls you out of the blue: it might work for a little while, but in the long run, you can't retire with it," Greer advises.

By reevaluating risks, returning to solid underwriting traditions and employing realistic pricing structures, surety companies are poised to help contractors succeed for the near and long term. By relying on the advice from a professional surety bond producer and underwriter, contractors have the opportunity not only to survive in today's market, but also to thrive.

Surety is about more than just receiving a bond—it's about helping contractors succeed and excel—in any market.

ISSUES SUCH AS INFLATION, A LACK OF GOVERNMENT FUNDING FOR PUBLIC WORKS AND SCARCITY OF CONSTRUCTION MATERIALS MAY COALESCE TO CREATE A MORE HOSTILE CONSTRUCTION ENVIRONMENT THAN WAS IN PLACE TWO TO THREE YEARS AGO."

Huntsman is communications manager for the Surety Information Office (SIO). For more information, contact SIO by email at sio@sio.org, call (202) 686-7463 or visit www.sio.org.

EXECUTIVE INSIGHTS

HOW CAN CONTRACTORS BEST ADAPT TO TODAY'S SURETY MARKET?

BY JASON HUNTSMAN

Terence Cavanaugh
COO
Chubb Surety
To succeed in today's market, contractors need to align themselves with the best possible advisors. Experienced construction-oriented CPAs, specialized surety bond producers and insurance brokers, and an expert legal team are all important external components for a successful contracting operation. A contractor should share financial and operational records with his or her surety on a regular, open basis. It is also key for the surety to develop an in-depth understanding of the contractor's management team and the company's overall approach to risk management.

Mike Peters
President
Safeco Surety
Contractors can adapt to today's surety market by making sure they have a solid relationship with their surety and are dealing with a professional surety agent. That way, when issues come up they can be discussed and hopefully resolved fairly quickly. This is also a good time to focus operations in areas where firms can consistently make money. Surety credit is valuable, so "spend it" wisely. Small and emerging contractors should stay focused on the core business or market they know well. Contractors should not get enamored with top-line growth unless they have built their balance sheet to withstand a poor job. Also, they should invest in the proper controls to fully understand the status of projects at all times.

Craig E. Hansen
Senior Vice President
Holmes Murphy & Associates, Inc.
President
The National Association of Surety Bond Producers
In today's surety market, contractors are being asked to supply more detailed financial statements on a more regular basis. Personal indemnity is much more likely to be required, and continued pricing discipline will occur, especially at the upper-end of the market where capacity is the primary concern of the contractor. In some cases, creative approaches to bonding will be needed—especially on long-term or mega-projects. Contractors working with a professional surety bond producer have a close ally who is well-informed and prepared to help the business adapt to these current market features.

William E. Cheatham
President
Zurich North America Surety
Most surety companies say they have returned to a back-to-basics approach to underwriting, which may mean to some nothing more than requiring accurate and timely financial data. More important may be emphasizing the need for a contractor to maintain a strong working capital and equity position. Lacking strong financial resources can leave a firm vulnerable. In today's market, contractors should focus on raising profit margins on projects—there is too much general acceptance of taking jobs at low profit margins. Also, contractors need to renew focus on accepting only reasonable contract terms and conditions. Accepting contracts that are onerous can lead contractors into peril. An important benefit of working with a surety company is the expertise that it can provide in a contract review—ensuring that a contractor's best interests are preserved.

Geoffrey Haver
Senior Vice President and Construction Practice Leader
Riggs, Counselman, Michaels & Downes, An Assurex Global Partner
A contractor can do several things to better position the firm in today's surety market. A contractor should: partner with a construction-oriented CPA, surety company and producer; keep all parties informed with frequent communication (sureties do not like surprises); retain profit to strengthen the balance sheet; supply timely and well-prepared financials; stay within areas of expertise; be wary of jobs that sound too good to be true; and continually train and educate project managers and estimators.

John Stanchina
Vice President
Rutherfoord Companies, An Assurex Global Partner
The key for a new and emerging contractor is to have a clear and concise business plan, construction-experienced CPA, professional surety agent and legal professionals. The other key is being reasonable with growth objectives on projects and programs in order to ensure systems and finances can support operations. The temptation among emerging contractors is to take every deal that comes down the pike—it is typically one of those projects that does not truly fit the firm's abilities that potentially puts the contractor at risk.

James E. Lee
President
Old Republic Surety Company
Chair of the Board of Directors
The Surety Association of America
Contractors should prepare their businesses for even the worst of situations. By developing strategies to address dire situations, a business can potentially come through intact. The end of the calendar year is approaching and is an excellent time to prepare meaningful financial statements that make sense to the user. It is advisable for the contractor to sit down with the surety bond producer and CPA to develop strategies for adapting to change. If a bonding program is terminated due to the departure of a surety or for another reason, are current solid financial statements ready if the need calls for making a presentation to another company?

Contractors should retain risk capital in their businesses and pay bills on time. Prompt payment to laborers and material suppliers is imperative, regardless of whether the particular parties are covered by a payment bond. Contractors also should take advantage of discount opportunities to save on material costs through prompt payments. Having an established unsecured bank line of credit is important not only to be able to make such prompt payments, but is also extremely useful should a contractor encounter a cash drain while waiting for receivables.

A SOLID CONTRACTOR WILL SPEND THE MONEY FOR A CONSTRUCTION-SPECIFIC ACCOUNTING AND ESTIMATING SYSTEM.

KNOWING JOB STATUS FROM A PROFIT STANDPOINT IS EXTREMELY IMPORTANT TO THE CONTRACTOR AND TO THE SURETY.

John Welch
President and CEO
CNA Surety
Underwriting in the surety industry remains disciplined. Surety companies are requiring retention of profits in order to grow net worth and working capital. Sureties also continue to improve their security positions, requiring personal indemnity where deemed appropriate. Contractors should find a professional bond agent and listen to his or her advice. There are fewer short cuts to getting bonding than there were in the 1990s. Solid work experience coupled with a reasonable level of risk capital will allow entry into the bonding market.

Phil Tobey
Vice President of Surety
The Dale Group
To best adapt to today's market, contractors need to keep an open mind and be prepared to make changes. Contractors should align themselves with a professional surety bond producer who works with a variety of sureties that possess various appetites for risk. The professional agent should be a problem-solver and close advisor. Sound advice from a surety professional is essential.

Michael F. Greer
Vice President Surety and Fidelity
Penn National Insurance
A solid contractor will spend the money for a construction-specific accounting and estimating system. Knowing job status from a profit standpoint is extremely important to the contractor and to the surety. Don't grow beyond the company's capability and don't go get the big job and then have to hire someone new to manage it. Be willing to walk away from work that doesn't fit and make sure to know where bids are going, whether to a general contractor or a public owner. Don't be the latest victim of the general contractor looking to pass off liability. Finally, read and fully understand all contracts before signing them.

Michael Cusack
Senior Vice President and Regional Surety Director
Aon Construction Services Group
Contractors should develop disciplined lines of communication with the bonding agent and surety underwriters; communicate effectively on a more regular basis with the surety provider; update the business plan throughout the year; avoid surprises by keeping underwriters updated on significant events; and make sure the underwriter understands the current strategy and agrees with the contractor's intermediate and long-term vision for the enterprise.

Contractors should be disciplined in the use of surety credit. A prequalification process should be implemented to ensure that companies are deploying their bonding resources in areas that will generate the greatest return for their organizations.

Michael Murphy
Vice President
Bush, Cotton & Scott
Sureties are paying close attention to the degree to which a contractor relies on his or her bank of line of credit. If a firm constantly maximizes its line of credit, then warning flags may be raised. Sureties like to see liquidity to be assured that a contractor can absorb problems.

Sureties also pay attention to the geographic areas where contractors work and their areas of expertise. Basically, a contractor would do well to stick to what it knows best. Whether switching from bidding on private jobs to public works, or moving into a new geographic area, changes of this nature raise sureties' concerns.

William A. Marino
Chairman and CEO
Allied North America
The expectations of sureties in today's marketplace are very easy to understand. They expect a quality financial presentation with sufficient levels of liquidity and loss-absorption power to meet the requirements of the current construction climate; a focused business plan with careful evaluation of any deviations and an eye toward risk management; and contracts entered with financially responsible parties with equitable contract terms and conditions.

Henry Nozko, Jr.
President
ACSTAR Surety
It is important that a contractor select a solid surety company and stick with it, treating it the same as a banking relationship. Shopping around and moving from surety to surety is not a good idea. A surety may feel more obligated to help a long-time client through a rough spot, whereas a contractor who bounces from surety to surety may be looked on less favorably. Maintaining the surety relationship is more important now than even a year ago. A contractor should carefully select a surety company and develop a sound relationship. This is vitally important, especially if all, or even a portion of a contractor's work, is in the public sector.

Mark Reagan
Chairman and CEO
Willis Construction Practice
Underwriting now focuses more on liquidity in a contractor's business and availability of capital at risk. For contractors, capital and earnings continue to drive the availability of surety capacity up or down accordingly.

While 10 years ago it was unusual for a sizeable account to have to post collateral, today it is not uncommon to ask for such and to have an inter-creditor lender involved. As sureties are taking on more risk, these steps ensure that they will have a place at the table should things go wrong on a project.

IT IS IMPORTANT THAT A CONTRACTOR SELECT A SOLID SURETY COMPANY AND STICK WITH IT, TREATING IT THE SAME AS A BANKING RELATIONSHIP.

For contractors, there is more complexity and leverage against success than at any time in the past two decades. The good and great contractors will thrive, while the average and mediocre will find their survival threatened. As active players in the construction process, sureties see these risk drivers and continue to take a cautious view on all but the very strongest accounts.

Michael D. Williams
President
North American Construction Services, Inc.
With the return to solid underwriting and the focus on working capital and net worth as well as the CPA reporting requirements, there are a number of capable entities facing challenges in receiving surety credit. One solution to the problem is funds control/escrow. This tool helps the contractor to meet the requirements of working capital and net worth by the surety requesting that a funds disbursement agreement be set up to monitor the project. Funds control alone is not the answer but flexibility of the tool is.

A surety can require working capital deposits into the escrow account that will assure the surety that funds are available to start and finish the project. An additional condition of injecting other funds into the escrow account that are held similarly to collateral tends to solve the net worth problem. The funds come from the personal liquidity or net worth that has been drawn out of the company and converted to hard personal assets. More and more contractors are seeking this solution, and obligees are delighted to have a third party adding comfort to the disbursement of the contract proceeds.

Stephen Pate
Senior Vice President
HCC Surety Group
Small contractors would do well by developing a truly clear-cut, consistent and credible set of financial statements. These should be shared with the surety not just on an annual basis, but also periodically throughout the year. In today's market, if a presentation does not conform to a surety's particular standards it may not receive favorable attention. With the help of a construction-experienced CPA, small contractors can develop a footprint of consistent, analyzable financials from year to year, whether they conform to audit, review or compilation standards.

The small contractor should pay close attention not only to business payments, but personal credit management as well. Because sureties are more likely to scrutinize personal financials of smaller firms, it is important to maintain a sound personal credit history.

Dennis Perler
President
Liberty Mutual Surety
This is an exciting time for the surety industry. The nation's aging and expanding infrastructure needs will continue to keep good public works contractors in high demand. Moreover, as the economy continues to improve, there should be increased public funding to rebuild roads, schools and other public works. While emerging from three difficult underwriting years, the surety industry today is ready to serve the nation's contractors. Most sureties recognize that stable and responsible underwriting is critical to maintaining long-term capacity and customer confidence.

Huntsman is communications manager for the Surety Information Office (SIO). For more information, contact SIO by email at sio@sio.org, call (202) 686-7463 or visit www.sio.org.

HAVE CONTRACT SURETY QUESTIONS? SIO HAS THE ANSWERS

BY MARLA McINTYRE

While contract surety bonds are an important component of a contractor's overall business operations, they are not exactly something learned in grade school. The underlying concept behind contract surety may be fairly simple, but there certainly is plenty of room for questions on the details.

That's why the Surety Information Office (SIO) was created—to answer contractors' and owners' questions, provide useful, practical information on all things contract surety and promote the use of surety bonds in public and private construction.

Established in 1993 by the Surety Association of America and the National Association of Surety Bond Producers, SIO offers a wide assortment of materials for contractors and subcontractors ranging from electronic resources to printed brochures and informational booklets—all available at no cost.

21ST CENTURY TOOLS

SIO's newest resource is an interactive CD-ROM, "Surety Bonds: A Guide for Contractors," which makes learning about contract surety bonds easier than ever. Created with Macromedia Flash software, the CD has many layers of interactivity and user control, as well as access to SIO's online contractor resources and links to useful websites. The disc contains three audio-narrated presentations, which cover the bonding process, the surety relationship and subcontractor bonding. Best of all, the presentations can be accessed from a computer at any time and surety bonding information can be absorbed at the user's pace.

PRINT PUBLICATIONS

One of the many free publications available to contractors, "How to Obtain Surety Bonds," serves as an excellent reference guide on the bonding process. This publication is ideal for any contractor venturing out in the world of surety for the first time, or those wanting a quick refresher for a staff member.

Another print resource created specifically with contractors in mind is "SBA's Surety Bond Guarantee Program," which details the U.S. Small Business Administration's program that helps small and emerging contactors that may not qualify for bonding through regular commercial channels to obtain bonds.

Other print materials address topics such as the importance of surety bonds; avoiding a construction business failure; electronic bonding; evaluating surety companies; and comparisons to other risk management products.

ONLINE ACCESS

The SIO website, www.sio.org, is another important resource available to contractors at any time of the day or night. The site contains an area dedicated especially to issues affecting contractors and subcontractors and offers specific information on a wide variety of topics.

The extensive FAQ portion of the site provides answers and supplemental information to questions such as:

- Where can I find contract documents and standardized bond forms?
- What is the Treasury List or T-list and how can I get a copy?
- Where can I get surety industry statistics?
- Is it possible to file a bond electronically?
- How can emerging or minority contractors get bonds?
- Where can I get information on subcontractor bonding?

INFORMATION CENTRAL

SIO is the resource on contract surety bonds and is available to provide a wealth of information on this valuable business tool. Take advantage of SIO's numerous free resources and industry insights. By developing an understanding of the bonding process, contractors can better position their businesses in a competitive marketplace.

McIntyre is the executive director of the Surety Information Office (SIO) in Washington, D.C. For more information, contact McIntyre at mmcintyre@sio.org or contact SIO by email at sio@sio.org, call (202) 686-7463 or visit www.sio.org.

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THE BIG PICTURE: SURETY IS MORE THAN A LINE OF CREDIT

BY MATTHEW ROSENBERG

Construction is an inherently risky business. Each year, thousands of contractors fail, leaving billions of dollars of uncompleted projects. Of those contractors that go out of business, statistics show that two-thirds have been in business for more than six years, while one-third have been in business for more than 10 years.

Serious problems arise when these construction projects are not protected by surety bonds. While most public projects are bonded, and taxpayers are protected by the security of a bonding company, only a smaller percentage of private projects are bonded, despite the tremendous benefits afforded by bonds.

The guarantee that the contractor will perform (performance bond) and pay its suppliers and subcontractors (labor and material payment bond) is the benefit provided to the owner (obligee). The obligee, which is the beneficiary of the bond, would prefer not to make a claim on the bond unless it's the last option. Rather, the obligee seeks assurance that the contractor will successfully complete the project and pay all of the suppliers and subcontractors. While the bond guarantee that the surety provides to the owner is of great importance, arguably the primary purpose of bonding is to prequalify contractors.

THE THREE Cs

Because surety underwriting is a continuum, no wonder many contractors develop close relationships with their agents and sureties. Bonding companies require timely financial information and frequent meetings. Contractors should work to foster a strong bond with a surety. The surety and the agent want clients to be successful–not only to prevent losses, but also to promote a healthy and profitable client.

For sureties, success relates to the Three Cs:

1. *Character:* The surety wants a sense that the company has the highest integrity and that the owner is honorable.
2. *Capacity:* Capacity is the expertise, manpower and experience to handle the project. Generally a surety will consider a project no larger than twice the size of the largest project completed by the contractor.
3. *Capital:* Capital is the financial strength to handle the total backlog of the company, whether the work is bonded or not.

MORE THAN JUST A GUARANTEE

Contractors can be only one bad subcontractor away from having an unprofitable job and three bad jobs away from going out of business. Along those lines, past due receivables devastate the cash flow and bond availability of construction companies.

Consequently, sureties continually underwrite their clients through detailed review of financial statements and job schedules. Financial statements must be reviewed or audited and received no less than annually, though often semi-annual review may be preferred. Accounts receivable are typically the largest asset on a contractor's balance sheet and are scrutinized closely. Annual meetings to discuss the year completed and the year ahead all play an important part of the underwriting process.

DEATH AND TAXES

Two certainties in life are death and taxes. Not many people like to talk about death or plan for it. But when it comes to business, estate planning is critical. The stock of many construction companies may be controlled by one or two owners. Sureties must understand how stock would be transferred and how estate taxes would be paid upon the death of a shareholder. Contractors should be just as concerned as their surety, if they want the company to remain in business after their demise. Estate planning is worth the effort in planning for the future benefits of loyal employees and family.

Estate planning should be a part of the overall business plan of any company. The best projects usually include detailed and accurate plans from the engineers and architects. Similarly, sureties view the superior contractors as those that have strategic business plans that chart the goals of the company into the future. This helps the surety understand the client's needs and desires and give advice about growing a bonding program.

Qualities of a Successful Contractor: A Surety Perspective

Contractors that obtain the most from their surety program possess many of the same traits:

1. They are highly disciplined and organized.
2. They stay within their niche and geographic territory.
3. They take calculated risks that involve great thought and debate within the organization and through advisors.
4. The best companies have a team of professionals that they rely on in decision-making:
   - accountant;
   - banker;
   - lawyer;
   - surety agent and company; and
   - insurance broker.
5. Highly successful construction companies set goals and plan for the future.
6. They develop solid internal controls such as hiring a qualified controller/CFO.
7. They know their cash flow and aged receivables (those over 90 days).
8. They keep track of the profitability on all substantial projects.
9. They can answer virtually every question a surety may ask or quickly find the answer.

JUST DON'T SAY NO

Everyone wants to hear the word "yes," but a surety sometimes says "no." Sureties may take issue with the job size, the type of work or the total workload (backlog) of the contractor client. Certainly, a discussion should occur prior to or immediately after a declination in case the underwriter does not have all the facts or does not understand all of the issues of the project. For example, the project could be more equipment-intensive, or the job could be exactly within the contractor's niche, but is simply larger than its typical project size.

On the other hand, the job may not be the best project for a contractor, and the surety sometimes proves to be the voice of reason. The surety should be viewed as a member on the board of directors. It provides a more impartial vantage point than the owners or executives of a construction company. The surety's unbiased and experienced viewpoint can prevent a problem before it is realized, or at least help a contractor get back on track.

Several years ago, a surety required one of its contractors in Sacramento, Calif., to obtain a bank line of credit despite the contractor's continuous objection. The surety's advice can literally save a client's business. Yet to this day, the contractor still complains at each underwriting meeting about the need for a bank line. What he fails to remember is that the bank line saved the company when it had some large past due receivables that almost devastated its wellbeing. Without the bank line, that contractor would surely be out of business today.

Occasionally, contractors are surprised to see competition that they do not hold in high regard on a bid list. Yet, some contractors are more financially secure than one might imagine. Some contractors may post collateral or use third-party funds administrators. Others may obtain backing from a company with more financial strength that cosigns on the indemnity agreement like a father cosigning his son's car loan.

These are not ideal methods of obtaining bonds. Sureties would rather see a company stand on its own merits through years of profitability, guided by a sound business plan.

Construction companies should remember three important points. First, remember that the surety provides business counseling as part of its service to clients. Second, the surety wants to work with companies that have a solid organization and a knowledgeable team of advisors. Finally and most importantly, the surety wants you to succeed as much as you do.

SURETIES VIEW THE SUPERIOR CONTRACTORS AS THOSE THAT HAVE STRATEGIC BUSINESS PLANS THAT CHART THE GOALS OF THE COMPANY INTO THE FUTURE.

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COMMUNICATION & SURETY CLAIMS

A Surety Can Help a Contractor Get Back on Track

BY TIMOTHY MIKOLAJEWSKI

One of the critical elements needed to establish and maintain a solid surety relationship is open communication. This is not only essential when times are going well, but also when times are not going as planned.

How a contractor handles the impact of a bad project or a bad year often determines whether a business will survive or fail. Because getting new work is usually critical to working through problems, maintaining a strong surety relationship is essential.

No one relishes delivering bad news. When contractors get into trouble, sometimes they tend to wait too long to let their surety know of the situation. As a result, when the surety becomes aware of the problems, many of the options available to handle those problems no longer exist. On the other hand, if the surety learns of a problem early on, it likely will have resources available to assist in solving the issue.

Most surety companies in the industry today have been around a long time. Because surety is a very specialized industry, most tenured professionals in the business have developed a significant amount of experience entailing both positive and negative situations with contractors.

As a result of having dealt with negative experiences over the years, a surety typically does not overreact to bad news. Rather, the surety works closely with the contractor to develop strategies to overcome any problems and get back on track. The earlier problems are communicated, the more likely they will be solved and the faster the contractor will be back on track.

Contractors do not want to communicate bad news for two reasons. One is a sense of optimism that other work will offset the bad job. Thus, when discussing the bad project with the surety, the overall impact could already be in the past.

Another is the perception that the surety will overreact and suspend surety support, or that a surety's claims operation will have to get involved. Obviously, these two outcomes are not ones a contractor looks forward to. However, being in a surety claims department does not necessarily mean a contractor has or will cause a surety a loss. In fact, a vast majority of activity in a surety's claims operation is related to issues involving solvent contractors that are getting continued support from the surety's underwriting team.

Surety claims fall into three basic categories. The first category involves a situation where a solid contractor has a legitimate dispute with an owner, a subcontractor or a supplier. Typically the dollar amounts are small and the ultimate outcome will be a settlement handled between the parties involved, with the claim resolved relatively quickly. Generally, this will involve very little activity on the part of a surety claims operation.

The second category of claims is much more serious, but the surety still does not expect an ultimate loss. These types of claims can be time-consuming and typically involve a great deal of interaction among the contractor, the surety claims operation and the underwriting team. Contractors that end up with claims in this category generally are experiencing problems with one job rather than having systematic problems. One project might have significant changed conditions, a difficult owner or poor design. While the contractor has the technical ability to complete the project, the cash drain is such that the contractor cannot complete the job without financial assistance.

A common thread in these situations is a strong claims case against the owner where the contractor can recover considerable money in a reasonably short period of time. The combination of this recovery and new work supported by the surety results in the contractor working its way out of the problem and getting back to normal business.

The above situation features one of the hidden values a project owner gets from a surety bond. The contractor's work with a particular owner or owners may be going along quite well. The owner would be surprised if the contractor said it could not finish the project. With the surety's assistance, the contractor can keep all work on track toward completion, honoring all obligations to owners, suppliers and subcontractors. Obviously, the contractor benefits by being able to continue in business rebuilding financial strength and making the surety whole. Communication is vitally important if a contractor and surety end up in this type of claims situation.

The third category of claims situations involves the contractor being unable to complete the work, thus needing the surety. When the situation gets this dire, it is difficult for the surety not to lose money. With considerable cooperation from the contractor, the loss to the surety has a good chance of being substantially mitigated. Hopefully, when a problem arises, early communication and cooperation between the contractor and surety can help avoid this scenario completely.

Open communication and cooperation provide tremendous benefits for all involved in the project—not just in claims situations. The owner receives qualified contractors to bid the work competitively, thus getting the best value for the project. The subcontractors and suppliers on the project receive payment bond coverage guaranteeing that if they are legitimately owed money they will be paid. The surety generates profitable premiums by writing the bond—giving financially sound surety companies the motivation to stay in the business and maintain a competitive surety climate.

And finally, the contractor maximizes its surety credit, allowing it to take advantage of opportunities to grow its business.

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COMPONENTS OF A SUCCESSFUL SURETY RELATIONSHIP

BY MICHAEL DOUGHERTY

The surety industry has paid billions of dollars of losses over the last few years. Now the industry sees a renewed effort to increase both the level and intensity of the underwriting process. More than ever, contractors must proactively manage their surety relationship. What does this entail? Below is a set of questions to help assess the level of the relationship you have with your surety carrier.

1) I know the name of the surety company that issues bonds on my behalf.
True False

2) My surety company representative is active in construction association events and is knowledgeable about local and regional market conditions.
True False

3) How often do you meet with a surety company representative?

a) Never	0 points
b) Every couple of years	2 points
c) Annually	4 points
d) Two or more times annually	6 points

4) I know the parameters of my bonding program and/or my total level of bonding support.
True False

5) I provide quarterly updates of my work-in-progress to my surety company.
True False

6) If I have a project that is going poorly and may impact my financial results, I inform my surety agent and bonding company as soon as possible and make sure they understand the issues and potential impact.
True False

7) I know the underwriting results of my surety company and their track record of profitability.
True False

8) I produce quality internal financial statements each month and provide them to my surety company on a quarterly basis.
True False

9) A representative of my surety company has visited one of my jobsites and I am comfortable the company understands my business.
True False

10) My surety company representative receives the same level of access and interaction as my banker and/or other credit providers.
True False

11) When considering a large unbonded project, I solicit input from my surety agent and/or company on the impact it could have on my firm and/or my surety bonding line.
True False

Score "2" points for every true response and "0" for every response marked false.

20–26	**Excellent**—you are proactively managing your surety relationship.
14–20	**Good**—your relationship is solid but could be improved.
8–14	**Needs Work**—consider increasing the level of contact and communication with your surety company and agent.
< 8	**Poor**—you may be a limited user of surety credit. However, if surety credit is important to your business, you should work toward significant improvement in the surety relationship.

A construction company's success will be determined by its ability to manage relationships successfully with owners, other contractors or subcontractors, suppliers, bankers, sureties and other credit providers. At the heart of any successful relationship is the need for timely information exchange, proactive communication and a clear understanding of each party's expectations. Make the time to develop a strong relationship with your surety bond producer and surety company representatives. In times of uncertainty, these relationships will be worth exactly the time and effort you spent building them.

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BONDING JOINT VENTURES

BY WILLIAM CHEATHAM

Joint ventures have gained increased popularity among contractors in recent years as the preferred means of sharing and mitigating construction risks. Joint ventures are primarily associated with large, complex and long-term projects. Few published statistics (if any) can help shed light on the risks and rewards of using joint ventures.

However, there has been only one surety bond loss involving a project performed under a formal joint venture arrangement. In a surety industry that has paid out $6.5 billion in direct losses on bonded jobs over the past 10 years, this speaks volumes about the merits of employing joint ventures as a risk-mitigation technique.

Not all joint ventures are successful. Those that are, tend to work because the capabilities, expectations and responsibilities of each party are defined well in advance of the first certification being drawn. Every joint venture is essentially a formal partnership between two or more distinct parties, each with its own set of circumstances, needs and perceptions of risk and reward. The more the partners know and understand each other, the more likely they will be successful in working together and using each other's strengths to maximize their own objectives.

Most successful joint ventures share these two common characteristics:

- They are made up of two or more organizations that understand what they want and expect from each other. They are confident that the other parties can perform and honor their share of the obligations.
- They rely on a well-defined joint venture agreement that clearly specifies the venture's business objectives and spells out the essential obligations; i.e., sponsorship percentages, assignment of the joint venture parties' several responsibilities, insurance coverages, funding and equipment contributions, personnel, procedures, purchases, management authority/controls, dispute and default resolution, profit recognition and distributions, assignment of rights, pricing, bank relationships, records and accounting policies.

WHY ENTER INTO A JOINT VENTURE?

The reasons for formulating joint ventures are numerous. More often than not, joint ventures form because of a mutual interest by two contracting parties in sharing and spreading the risk associated with large, complex or long-term contracts, which could have dire consequences if all does not go as planned. Other reasons can be as simple or as varied as:

- to tap one another's unique skills and/or assets (equipment, personnel);
- to gain complimentary skills or pool resources;
- to take advantage of local geographic and/or sub-trade knowledge and expand market penetration;
- for political connections and/or owner relationships;
- to maximize surety capacity and/or influence surety underwriting;
- to meet set aside requirements;
- to obtain pricing security (i.e., second opinion);
- to strengthen financial structure and/or prequalification validation;
- to meet prequalification requirements—experience, capacity, licensing; or
- to comply with federal, state or local regulations/bidding requirements.

There is no standard joint venture—they can take several forms. While most are prime and limited in scope to a single job, a joint venture can be incorporated or even left open indefinitely, with the ability to take on new projects all the time. Some joint ventures are silent, with only one contractor appearing on the contract and/or bond, but this situation does not lessen the silent party's duty to perform or indemnify all of the contractual obligations. The form a joint venture takes is often determined by the nature of work, size, duration of the contract, skills and qualifications of each joint venture partner.

RISKS

Each contractor should consult its attorney, insurance agent/broker and accountant before entering into a joint venture agreement because of legal obligations, insurance issues and tax consequences.

Use care in selecting joint venture partners as each will be fully liable (jointly and severally) to the owner, subcontractors, suppliers, third-party claimants and sureties, irrespective of the defined obligations of the joint venture agreement.

It is not only proper, but also obligatory for each party in the joint venture to ask for and receive a full disclosure of the financial standing, work programs and other commitments of each prospective partner—and to provide the same when asked. It is common practice for the respective sureties to underwrite the finances and capabilities of the counterparts to a joint venture and prequalify the joint venture in its entirety.

Sureties do not look favorably on "angel deals" in which a contractor lends his balance sheet to another for surety capacity while having no real involvement in the management and execution of the bonded project. With the increased emphasis on surety prequalification of contractors, some construction firms attempt to leverage their lack of surety capacity by using another firm's surety credit.

Joint venturing can be a beneficial way to gain additional work and experience and expand a firm's market penetration. But it should only be approached with full appreciation of the risks involved, full knowledge of the prospective joint venture partners and after consultation with an attorney, tax accountant and surety all familiar with joint venture obligations.

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THE SURETY BOND PRODUCER: A CONTRACTOR'S LINK TO BONDING SUCCESS

BY CRAIG E. HANSEN

The ability to obtain surety bonds is more than gaining access to new markets—it's about building business relationships. The surety industry has gone through a number of changes in the past five years—including a number of high-profile mergers and departures—and the relationship between contractor and producer has become more important than ever.

The primary purpose of a surety bond is to provide project owners assurance that the contractor is prequalified to bid and build the specific project. As such, a surety bond producer will work very closely with a contractor to ensure that a surety company's underwriting criteria can be met. Professional surety bond producers can serve as an objective, external resource for evaluating a contractor's capabilities. As an advisor, the producer may offer insights about how best to adapt a contractor's business plan to a surety company's underwriting needs.

In today's surety market, contractors are being asked to supply more detailed financial statements on a more regular basis. Personal indemnity is much more likely to be required, and continued pricing discipline will occur, especially at the upper-end of the market where capacity is the primary concern of the contractor. In some cases, more creative approaches to bonding will be needed—especially on long-term or mega-projects. Contractors working with a professional surety bond producer have a close ally who is well-informed and prepared to help the business adapt to these current market features.

Contractors who have established solid relationships with a surety bond producer and surety bond company during these times of change should consider the value of such relationships. Having a long-standing business relationship is an intangible, yet invaluable asset. A contractor should think twice before abandoning such relationships, especially during times of uncertainty.

While the surety credit limits and underwriting terms may not always be to a contractor's liking, the surety company and surety bond producer will work diligently to help a contractor meet its bonding needs. Surety credit is no longer available to just anyone, however, well-capitalized and well-managed contractors can use these somewhat turbulent times as a competitive advantage in the marketplace.

Contractors seeking to establish a new bonding program would be well-advised to seek out the services of a professional surety bond producer. It is essential that a contractor work with a qualified, competent, professional surety bond producer to obtain the best advice and insights that have a business' long-term interest in mind.

A surety bond producer does not act merely as a gatekeeper to the surety companies. He or she possesses a wealth of knowledge about the latest trends and legal issues affecting the surety industry and acts as a close advisor to contractors to help them navigate the rigorous prequalification process.

The specific roles of a surety bond producer are numerous and diverse. A surety bond producer:

- Matches the needs and strengths of the contractor to the surety company that will best support the contractor;
- Offers sound business advice, management consulting services and technical expertise—or introduces the contractor to appropriate professionals or consultants;

What to Look For in a Surety Bond Producer

A professional surety bond producer:

- is well-respected and has a reputation for integrity in the construction industry;
- demonstrates a personal interest in the contractor's success;
- has a track record of building solid relationships with surety underwriters;
- possesses an understanding of the construction industry;
- has knowledge of accounting and finance, especially construction accounting procedures;
- has knowledge of construction contracts, subcontracts and related contract law;
- is aware of local, regional and national construction markets;
- is experienced in strategic planning and management practices that promote successful contracting; and
- is actively involved in and supports local and national construction and surety industry associations such as the National Association of Surety Bond Producers (NASBP) and Associated Builders and Contractors.

WHETHER A CONTRACTOR IS SEEKING A BOND FOR THE FIRST TIME OR WANTS TO CONTINUE TO GROW A BONDING PROGRAM, THE ADVICE AND INSIGHTS AVAILABLE FROM PROFESSIONAL SURETY BOND PRODUCERS ARE INVALUABLE IN TODAY'S MARKET.

- Compiles financial documents for submission to the surety. In some cases, the producer may analyze the financial statements to determine the contractor's working capital, net worth and current revenue;
- Reviews contract documents to determine if the contractor is taking excessive risk;
- Conducts a background investigation of the contractor's past contractual obligations;
- Recommends a responsible line of credit consistent with the contractor's capabilities;
- Tailors the contractor's submission for the specific needs and requirements of the surety company and guides the contractor through a formal presentation; and
- Maintains communication between the contractor and surety company with periodic reports on work progress, financial performance and business plans.

Whether a contractor is seeking a bond for the first time or wants to continue to grow a bonding program, the advice and insights available from professional surety bond producers are invaluable in today's market.

For more information on surety bond producers, visit the National Association of Surety Bond Producers website at www.nasbp.org and click on "Need a Bond," or call (202) 686-3700. NASBP members are professionals in the surety bond marketplace and adhere to a code of processional standards.

Hansen is senior vice president of Holmes Murphy & Associates, West Des Moines, Iowa, and president of the National Association of Surety Bond Producers (NASBP). For more information, contact NASBP at (202) 686-3700 or email, info@nasbp.org.

THE "THREE Cs" OF SURETY ...THEN AND NOW

BY MIKE ANDERSON

Many contractors are familiar with the three Cs of surety, the three factors that sureties have historically employed in underwriting the construction industry: capacity, character and capital. Unprecedented surety losses, industry consolidation and other factors have transformed this historical model. There are still three Cs, but their definitions have changed.

THE FIRST C OF SURETY

Then: Capacity—the Contractor's
Now: Capacity—the Surety's

Capacity used to refer to a contractor's capabilities in managing its work and financial resources. These fundamentals certainly remain critical to obtaining surety bonds, but the term capacity in the surety industry today more often refers to a surety's ability or willingness to provide sufficient levels of bonding to support its contractor clients' business plans.

The surety industry as a whole suffered another poor year in 2003. The Surety Association of America reported an industry-wide net-loss ratio of 62 percent, meaning sureties—in total—lost roughly $1.15 for each dollar of premium written. While some sureties enjoyed good results in 2003, returning to profitability as the result of the increased underwriting and pricing discipline that began in early 2001, most did not.

Surety reinsurers (those companies that share sureties' risk) are looking at a sixth consecutive loss year. Loss development on prior year claims has been significant—indicating the industry's poor results in 2001 and 2002 were actually worse than initially posted. This was demonstrated in late July, when a leading surety announced an increase in reserves of more than $600 million. It is too early to gauge the reaction of reinsurers to this action, but the size of the reserve adjustment alone will significantly impact the surety industry's overall 2004 results. Underwriting discipline has restored profitability to some major surety players, but as of June 2004, the Surety Association of America reported an industry-wide loss ratio of 77 percent for the first six months of the year. In the first six months of 2004, sureties incurred an additional $1.48 billion of losses—prior to the $600 million reserve increase. This means, overall, the surety industry is again losing well over a dollar for each dollar of premium it writes.

In a nutshell, large buyers of surety credit or any contractor that has experienced poor financial results can expect the cost of available surety credit to continue to rise and involve additional security or collateral.

A tempering factor on rate inflation is competition for middle-market contractors' business (defined as those with work programs of $20 million to $200 million). The cost of reinsurance and the changes in some major sureties' business models have driven this phenomenon. This sector of the market also has seen an influx of competition from regional sureties that have benefited from a migration of surety reinsurance away from national writers. Even these middle-market contractors, however, have experienced increased underwriting scrutiny, requirements for information and, in some cases, changed terms.

Historically, contract surety premiums have constituted between 55 percent and 60 percent of total surety premiums. The charts (see next page) illustrate contract surety results compared to construction activity in the United States over a 15-year period ending in 2002 (2003 contract surety data is not yet available). The "Value of Construction Put in Place" represents the value of public and non-residential construction expenditures as a rough equivalent of bonded exposures. The numbers are actual and not adjusted for inflation. Comparisons to the Consumer Price Index indicate that surety pricing, in aggregate, trailed inflation by roughly 40 percent from 1990 to 2000. As the graph illustrates, sureties have begun to close the "risk gap" of pricing relative to bonded exposure to a level that, historically, has proven profitable.

Another trend receiving increasing attention from contractors and owners alike is the reduction in financial ratings of sureties, their parent groups and reinsurers. These reductions affect the ability of companies to write business, raise capital and find acceptable co-surety partners or partners in joint venture project bonds. All indications are this will be an increasingly high-profile issue for contractors in 2005 and beyond.

Some new surety capital “put a toe in the water” in 2003 and reinsurance capacity has expanded in 2004, although with no relief on pricing or terms. Arch entered the business by retaining Kemper’s surety team. Berkshire Hathaway established a shared reinsurance facility with AIG to support large contractor programs with capacity. Quanta entered the commercial surety market. Rather than reflecting a return to a more accommodating underwriting environment, these initiatives may well represent opportunistic capital that will be employed in underserved markets and with discipline.

Access to capital remains the issue for surety managers. Competition for capital has fundamentally changed the way reinsurers view the surety line of business. In the past, capacity was allocated based on prior loss experience and underwriting practices. Since the surety losses of 2001, reinsurers have focused on terms of exposure and the potential dollar loss any single risk might generate, regardless of a surety’s underwriting track record. This exposure-based modeling has the potential to impose even greater demands for capital to support the same level of written premium. Already it has increased reinsurers’ scrutiny on individual accounts within a surety’s book of business and precipitated the withdrawal of support for certain types of surety bonds.

THE SECOND C OF SURETY

Then: Character
Now: Consolidation

Character has always, and will continue to be, a critical part of the surety equation. Character is often what allows a surety to extend credit to a contractor when the numbers might indicate otherwise. Consolidation in the surety industry, however, has been a key driver in the contraction of available surety credit. Over the past five years, the market share of business written by the top dozen writers has increased from 63.1 percent to 71.3 percent.

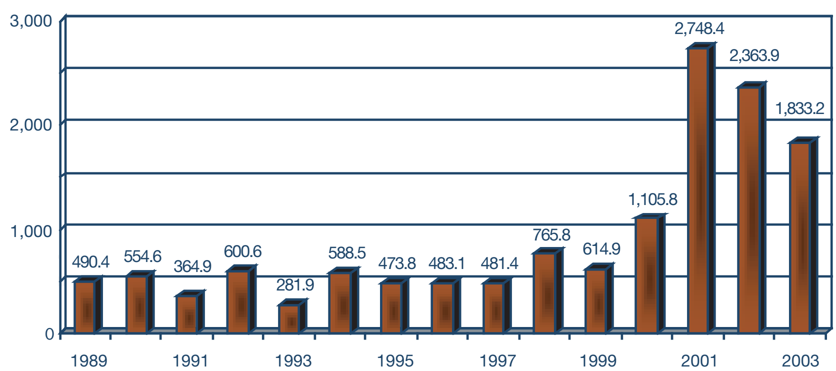
The merger of St. Paul and Travelers, the latest in a series of significant surety mergers and integrations, will create a surety operation with a market share that is more than double that of its next largest competitor. The capital demands of the surety line, driven by the requirements for increased retention of risk at the primary surety level, are likely to force further economies of scale. Continued consolidation will serve as a governor on the surety industry’s ability to expand capacity.

THE THIRD C OF SURETY

Then: Capital
Now: Communication

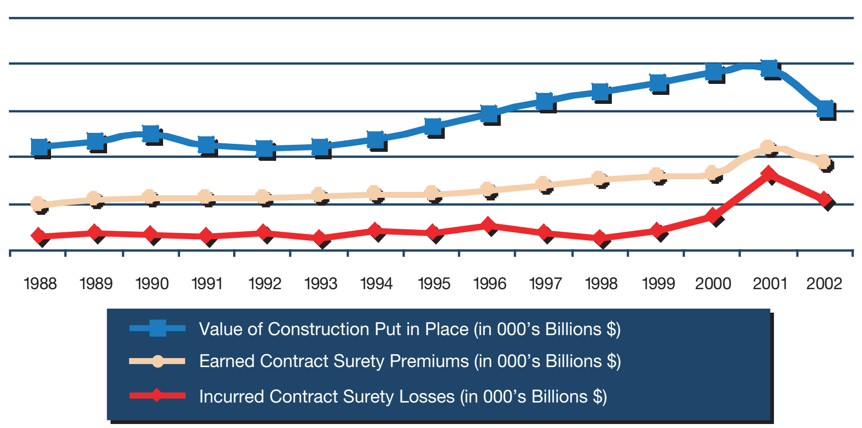
Users of surety credit will never be able to obtain surety support without capital at risk. In today’s marketplace, however, those contractors that most effectively communicate with their sureties about how they plan to manage and grow the capital base of their companies will enjoy advantageous terms.

Many successful firms work with their surety underwriters as they would with investors or lenders. Professional surety underwriters understand the up-and-



In the period from January 2000 through December 2003, sureties incurred more than $8.05 billion in losses, an amount higher than the total losses over the prior dozen years.

Source: Surety Association of America



By December 2002, the gap between ‘bonded exposures’ and surety premiums returned to an order of magnitude of roughly one, comparable to that which existed during a period of profitability for sureties in the early 1990s.

Sources: United States Census Bureau data and Surety Association of America data.

down nature of the construction business and would rather a contractor client bring them bad news or poor results than surprises. Whether it is a bad project, a prospective shareholder buy-out or difficulties in getting paid by an owner, the sooner the underwriter is brought into the loop, the better the chances of minimizing or avoiding any impact to the client's bonding line.

Sureties are giving individual contract provisions increased scrutiny and negotiating pricing for individualized risk. Some sureties have begun implementing surcharges for capacity, extended warranty obligations and other risk-specific considerations—such as long-term contracts (e.g., those with durations beyond 24 months). Recent material price increases for steel, lumber, cement and fuel have made sureties more interested in a contractor's risk analysis, particularly for fixed-price work.

Sureties have been increasing security and personal indemnity requirements. A number of underwriters now incorporate security interest provisions in their general agreements of indemnity and require that their security package be on par with a client's lenders. Many agreements now contemplate a surety enforcing the indemnity within a bankruptcy proceeding, not necessarily with a view toward working through a solution with the contractor. Any request by a surety for new indemnity agreements should be carefully reviewed by a surety broker and an attorney to assure its provisions do not conflict with existing security given to other creditors.

The increased demands of the current marketplace put underwriting staff under pressure. Lead time, as well as clear, concise financial reporting and detailed project risk analysis can be the difference between acceptance and declination.

Communication in a surety relationship should run in both directions. Contractors should question their surety about the financial quality and stability of the surety's parent company (when applicable), its surety reinsurance partners, the surety's own results and any anticipated changes in the surety's capacity or underwriting approach.

Key Players in the Surety Industry: 1999 vs. 2004

1999	Those Sureties as of July 2004
St.Paul	St.Paul / Travelers / Fireman's Fund
Zurich	Zurich
CNA Surety	CNA Surety
Reliance	Sold to Travelers in 2000
AIG	AIG
Travelers	To merge with St.Paul in April 2004
Liberty Mutual	Liberty Mutual
Frontier	Exited the business in 2001
Chubb	Chubb
Fireman's Fund	Sold Surety renewal rights to St.Paul in 2002
Safeco	Safeco
Amwest	Exited the business in 2001

Source: Surety Association of America data

STEPS TO TAKE

Contractors can take the following steps to increase the stability of their surety relationship:

- Be certain surety underwriters are fully aware of all aspects of a company's business plan and information is presented in a way that clearly addresses the true risk profile of the plan. From financial benchmarking to programs that reduce project scheduling risk, several tools are available to maximize the surety credit extended to a firm.
- Review strategies to protect the company's balance sheet. The balance sheet's condition or exposure is directly related to the surety's determination of how much surety capacity it will extend. Proven methods are available to identify and creatively fund both project risk and enterprise risk in ways that can improve a contractor's bottom-line results.
- Investigate, with the assistance of a professional surety broker, co-surety structures and stand-by surety relationships to assure capacity and continuity of surety support regardless of marketplace events. Ask a broker how it monitors a surety's financial ratings.
- Examine, where appropriate, alternative subcontractor performance default risk solutions. These solutions can increase the control a client has over its management of this risk and create opportunities to widen the participation of minority business enterprises (MBE), women's business enterprises (WBE) and other subcontractors that might otherwise be qualified, but cannot obtain bonding in today's marketplace.
- Employ a professional surety broker with sufficient resources to continually anticipate market conditions that might impact a surety program. If a broker does not maintain regular contact with senior surety executives, its clients may fall behind the information curve.

Those buyers and users of surety credit expecting a return to a more relaxed environment for obtaining surety credit have to wait a bit longer. Managers of surety capital and surety reinsurers still concerned about the industry's results may have not seen the worst. While clear indications of a return to a soft commercial insurance market exist where surety is concerned, the primary factor in obtaining surety capacity today is the nature and duration of a contractor's exposures. This fundamental shift in emphasis may be why the surety marketplace will remain constricted despite any market softening on the insurance side.

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THE CURRENT INSURANCE CLIMATE FOR CONTRACTORS

OCIPs Can Cover Difficult-to-Insure Losses

BY KENT THOMAS, CPA

Declining interest rates and skyrocketing litigation costs are just a couple factors affecting the insurance industry over the past few years. These changes have led many contractors to become resourceful with various insurance coverages.

Contractors have found several strategies to weather the current insurance climate.

THE PLUSES AND MINUSES OF OWNER-CONTROLLED INSURANCE

If the insurance policies necessary for the typical construction project were scattered over a jobsite, they'd probably come close to covering every square foot. Owners, general contractors, subcontractors, architects and others involved in the project all want to protect themselves from risk.

All of these policies may provide individual parties with the coverage they want, but the policies can prolong claim resolution with extended infighting and finger pointing. In addition, multiple policies add to the cost of the project.

In response to these complications, more and more owners have embraced a different option in recent years: owner-controlled insurance programs (OCIPs). Because OCIPs allow owners to buy master coverage for all project contractors, these policies can save 1 percent to 1.5 percent of total project costs.

EXPANDED COVERAGE

OCIPs are nothing new. They've been around since the 1950s. But they've become almost common now, not only because volume buying gives owners discount purchasing power, but also because OCIPs sometimes provide coverage that can otherwise be cost-prohibitive or unavailable to individual contractors.

OCIPs can cover difficult-to-insure losses associated with mold, pollution and exterior insulation and finish systems. But do they benefit contractors along with owners? That depends, experts say.

On the plus side, OCIPs sometimes provide coverage not included in an individual contractor's policies. Certainly this blanket coverage is more convenient for a contractor and, with its single-source responsibility, a properly administered OCIP can speed claim resolution.

In addition, OCIPs may open the door for projects that might otherwise be blocked by problems obtaining insurance coverage, such as multi-family residential buildings. But OCIPs aren't the answer for every project. Contractors should learn as much as possible about their provisions before bidding on projects.

POSSIBLE PITFALLS

One of the biggest pitfalls for contractors is completed-operations coverage. Though state laws vary in time limits for claims after construction is complete, most of these claims come more than five years after occupancy.

If the OCIP limits coverage to five years after completion, a contractor could find its company uninsured. Contractors can face this exposure even if liability policies would ordinarily cover 10 years after completion, because many contractor insurance policies exclude work performed under an OCIP.

Before bidding on an OCIP project, discuss the potential exposure with an insurance advisor. Bids should reflect a full understanding of all risks.

First, be sure to completely grasp existing insurance coverage to accurately assess risk. In some cases, OCIPs may provide better coverage than an existing policy. In other cases, a company may need to adjust its pricing to reflect uncertainties that come with an OCIP.

COST WORKSHEETS

Usually, contractors bidding on OCIP projects must submit a cost-calculation worksheet showing insurance costs without OCIP coverage. The owner then deducts that expense from the winning proposal. Be sure the deduction is not greater than the true cost of insurance.

In addition, OCIP contracts typically require contractors to perform administrative duties that aren't likely to be reimbursed for the extra costs that come with those tasks. OCIPs also eliminate contractors' markups on insurance costs, cutting off the possibility for recovering extra administrative overhead expenses.

SOME BENEFITS

OCIPs probably offer more real benefits to owners and developers than to contractors. But with care and expert advice, contractors can participate with confidence in projects covered by these policies.

HOW TO DEAL WITH THE LIABILITY INSURANCE SQUEEZE

After weathering two decades of unrestrained construction defect litigation, many liability insurers are opting not to write coverage for residential contractors. Others are attaching exclusions to contractors' general or umbrella liability policies or limiting the geographic regions or the percentage of problematic work allowed.

Construction defect litigation has become so widespread that some law firms now specialize in it. Most claims involve multi-family residential developments such as condominiums or townhomes, though dissatisfied single-family homeowners also initiate lawsuits.

At times, the suits are related to only minor defects, but industry analysts estimate litigation has added an average of $20,000 each to the cost of housing units in Southern California alone.

COVERAGE DIFFICULT TO FIND

As a result, contractors relying on liability coverage against construction defect claims find it increasingly difficult to obtain that coverage. When they do, the price is high.

Subcontractors are particularly vulnerable, as claims against other contractors often touch them, too. Some subcontractors left the residential construction market when insurance became unavailable or prohibitively expensive.

The good news is that a number of states have enacted "right-to-repair" laws that require homeowners (or homeowners' associations) to give builders the opportunity to correct any problems before initiating legal action.

These laws establish procedures intended to keep legitimate construction disputes out of court, to curtail frivolous suits and to detail responsibilities of both builders and buyers.

These laws are expected to help reopen insurers' doors to contractors by reducing the threat of legal judgments. But in states without such laws, contractors can do little to avoid being named in a construction defect suit or to obtain affordable insurance coverage.

SIGNIFICANT LIMITATIONS

Even when they continue to offer construction liability coverage, insurance companies are putting significant limits on that coverage. One court ruling in particular has reduced liability insurance availability: The California Supreme Court ruled in 1995 that knowing about losses or potential losses at the time an insurance policy is purchased does not invalidate coverage until the insured's actual degree of liability has been determined.

As a result, insurers have developed "known injury or damage" provisions excluding injuries or damages from conditions known at a policy's inception.

In addition, many insurers have targeted a number of common types of construction defect claims for exclusionary endorsements. At the top of the list is damage related to the use of synthetic stucco, or exterior insulation and finish systems (EIFS).

Contractors involved even indirectly with this regionally popular building material are often not covered for any injury or damage connected to it. Seemingly unrelated subcontractors, such as roofers and window installers, are not immune either, if their work can be tied to damage resulting from moisture penetration of EIFS.

MOLD OFTEN EXCLUDED

Mold is another area that has prompted exclusions. Although the long-term effects of toxic mold on people remain uncertain, it can clearly produce significant property damage. And because of the number of mold claims, even pollution liability insurers now routinely exclude mold from their policies, though some will provide coverage for an additional premium.

Coverage also may exclude damage caused by earth movement or subsidence, including landslides, earthquakes, mudslides, settling or erosion. For subcontractors, insurers may exclude residential construction as a class. This exclusion on a subcontractor's liability policy can affect coverage a contractor may have had as an additional insured under the policy.

CLOSE STUDY NEEDED

Contractors must examine their policies carefully for language limiting coverage. For example, some EIFS exclusions may eliminate coverage for every part of a structure with EIFS, regardless of whether a claim arises from the EIFS section.

In any case, in addition to stringent quality control, contractors can best defend themselves against the onslaught of construction defect litigation by acquiring a detailed understanding of their insurance policies and monitoring those policies for revisions that may increase their exposure.

CONTRACTORS MUST EXAMINE THEIR POLICIES CAREFULLY FOR LANGUAGE LIMITING COVERAGE. FOR EXAMPLE, SOME EIFS EXCLUSIONS MAY ELIMINATE COVERAGE FOR EVERY PART OF A STRUCTURE WITH EIFS, REGARDLESS OF WHETHER A CLAIM ARISES FROM THE EIFS SECTION.

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CRISIS MANAGEMENT— THE ULTIMATE JOBSITE SAFETY ISSUE

BY BRYAN C. JACKSON

Contractors and owners must continue to strive for the safest jobsites possible. Perhaps the ultimate jobsite safety issue, which is often overlooked, is the drafting and implementing of a well-reasoned crisis management plan.

Most companies focus on avoiding the traditional jobsite safety risks and common construction problems, such as cost overruns, delays and defects. However, contractors and owners also must devise contingency plans in case of war, terrorism, earthquakes and extreme weather that can destroy projects or their supply lines.

Crisis planners must carefully identify all risks, list potential damages, create a step-by-step response, establish emergency response teams, analyze back-up or redundant systems, stockpile emergency supplies, plan evacuation routes, set up information procedures and provide strategies for restoring the project quickly.

A pre-job risk-assessment strategy can alert contractors to these and other worksite dangers.

IDENTIFY THE RISKS

Crisis management plans often can be inadequate because they do not take into account all the significant potential risk that may be encountered. At a minimum, planners should consider:

- terrorism;
- war;
- civil unrest;
- vandalism;
- labor strife;
- fire;
- explosion;
- extreme weather, including wind, thunderstorms or a storm surge;
- earthquakes;
- slope failures;
- structural collapse;
- drought; and
- accidents.

In addition, planners must consider the reliability of equipment, fuel and supply sources. For example, a foreign supplier could fail due to civil war, terrorism or extreme weather. Can this risk be avoided by negotiating preferential contracts that require the supplier to guarantee delivery of supplies or paying the increased costs for supplies provided by others? A contractor or owner must consider stockpiling, specifying alternatives, increasing security or utilizing alternate transportation to shore-up supply lines.

LIST POTENTIAL DAMAGES

After identifying the potential risks, planners can list the possible damages. For example, a terrorist attack may topple structural elements, injure workers, rupture gas lines and cause explosions. Planners must consider and analyze these potential scenarios from the most likely to occur to the least likely, and then list the damages that may result.

SET STEP-BY-STEP RESPONSES

After listing the risks and damages, planners can identify case-specific responses. For example, if a terrorist act causes a gas fire, the crisis plan can prescribe step-by-step responses. The plan may direct the team to turn off the main gas valve, circuit breakers or temporary power to avoid additional fires, and then direct the team to rescue the injured. The crisis plan also may warn the response team to sweep for terrorist traps when turning off valves to ensure more effective firefighting and rescue operations can occur.

ESTABLISH EMERGENCY RESPONSE TEAMS

Disasters may occur throughout a wide area. In addition, terrorists could strike after a natural disaster has already depleted police or fire resources. Accordingly, a crisis plan should require the company's personnel to be trained for emergency response. Planners might survey employees to determine their training levels including:

- search and rescue;
- first aid;
- CPR;
- nursing;
- paramedic training;
- fire extinguisher use;
- emergency extraction;
- bio-hazardous handling;
- radioactive materials training;
- spilled containment training;
- red tag training;
- electrical engineering;
- communications skills;
- communications repair; and
- computer repairs.

Emergency training must be up-to-date and periodic drills should be carried out to sharpen skills. Drills often result in revised plans, wiser strategies and better coping if a real emergency occurs. Also, response teams need easy access to multiple copies of the plan in a disaster. Finally, multiple response teams should be formed in case some of the team members are not available or need to be rescued.

ANALYZE REDUNDANCIES

Identify primary and secondary urgent care facilities. Alternative shutdown and security procedures should be explored in case the primary shutdown and security procedures cannot be accessed. For systems controlled by computers, manual turn-off or override systems should be considered and protected from terrorism. In addition, planners should place emergency supplies in various areas of a project to provide redundancies.

STOCKPILE EMERGENCY SUPPLIES

Planners should place emergency supplies in various areas to provide easy access. Emergency supplies may include:

Contractors and owners must devise contingency plans in case of war, terrorism, earthquakes and extreme weather that can destroy projects or their supply lines.

- hazardous materials suits;
- back-up systems;
- back-up communications;
- rinse areas;
- separate storage areas for volatile chemicals;
- exit and danger signs;
- containment equipment;
- spill kits;
- first-aid kits; and
- emergency generators.

PLAN EVACUATION ROUTES

Planners should create evacuation routes and personnel accounting (check-out) systems and provide evacuation signs and emergency lighting. Primary and secondary evacuation routes with strict check-out systems allow planners to know who is left in the damaged structure. Consider call-in or web-based check-out systems, but remember a disaster may shut down telephone lines.

A check-out system allows rescue teams to determine who might still be inside burning or collapsed structures and avoids placing emergency teams at risk to search for employees who have already left the building.

SET UP INFORMATION PROCEDURES

Dissemination of information on a timely basis is critical. Planners should designate authorized personnel to disseminate information. Such spokespersons should provide accurate, up-to-date information regarding the crisis, response and injury status.

Preplanned statements can assist spokespersons in gathering their thoughts in times of crisis. Such preplanned statements avoid admitting liability for the disaster. Company counsel should assist in drafting such text.

PROVIDE A PROJECT RESTORATION STRATEGY

Once the crisis stabilizes, strategies should be employed to restore the construction project quickly. If significant injuries or loss of life occur, specialized counseling and a period of mourning is essential to begin the healing process.

Careful documentation of the damages, including photographs, video and reports, by reliable parties is necessary to pursue insurance and relief agency claims. In cases of death or injury, legal counsel should be consulted immediately, and the Occupational Safety and Health Administration (OSHA) must investigate all injuries or deaths. Counsel should retain independent consultants to preserve evidence and evaluate the causes of various injuries or damages. These reports may be kept confidential, if necessary.

Restoration procedures should be ranked from the most critical to the least critical. Planners should provide step-by-step processes for turning off all equipment, checking all utilities for damage and then energizing equipment one piece at a time to avoid damage.

Emergency generators may be required. Many emergency planners negotiate generator supply contracts in advance to keep track of costs. Engineers can evaluate safety measures before construction resumes. Also, security personnel can solve security breaches that may have allowed terrorism to occur.

If a widespread disaster occurred, alternative communications through cell or satellite phones may be critical to restoring the project and disseminating information.

It is never too early to start planning for a potential crisis. Various emergency response agencies that might assist in crisis planning include fire departments, health departments, the U.S. Department of Agriculture, OSHA, police/sheriff departments, security consultants, utility companies and legal counsel.

In short, the time to create and implement crisis management plans is now, well before any actual crisis occurs.

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