How a Surety Team Prevents and Remedies Contractor Default

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••For contractors and lenders, surety underwriters and surety bond producers are a valuable resource. Their experience and knowledge can help contractors avoid extreme risks and overcome challenges.

BY MARC RAMSEY

CONTRACT SURETY BONDS protect construction-project owners, their investors or stakeholders, and their lending institutions by assuring that the contractor is, in the surety's opinion, capable of performing the contract, that certain subcontractors and suppliers are paid, and that the contract will be performed in the unforeseen event of contractor default. Behind the scenes, though, surety bonds often have a broader effect. It starts with the relationship that the surety underwriter and bond producer have with the contractor.

Surety underwriters and bond producers use their experience and knowledge in surety, construction, contracts, strategic planning, business, and finance to prudently underwrite the risk. These skills have the side benefit of helping construction contractors avoid extreme risks, grow in a disciplined manner, and overcome challenges. When lenders require a surety bond as a condition of a construction loan to the project owner, they can be confident that their investment is protected.

Strategic Advisers

The underwriter and bond producer play vital roles in the success of a construction contractor's business. In underwriting and issuing the bond, they perform functions similar to experienced strategic advisers by providing advice and sharing corporate and agency knowledge gleaned over decades of construction involvement. The surety relationship is among a contractor's most valuable.

Because the surety must gain an in-depth knowledge of the contractor before providing the bond, the underwriter and bond producer often facilitate frank discussion with their contractor clients about issues such as business plans and best practices. They challenge their contractor clients to strive for improvement during robust construction cycles so they can sustain themselves in inevitable down cycles, thereby avoiding a loss under the surety bond. The surety team is well positioned to see not only the local and regional markets but also the national market. Surety professionals share their broad perspectives on what works and what doesn't, especially when their contractor clients seek a bond for a project that involves moving into new territories or new lines of work.

The underwriter and bond producer generally advise contractors against moving into new territories or entering new scopes of work. Experience has shown that such activities are primary factors in contract defaults and losses under the bond. In many cases, even though a contractor is suffering, it is more costly to venture into unfamiliar territory or take on unfamiliar work.

In addition, because financial strength is a key to avoiding contractor defaults and bond losses, underwriters and bond producers provide feedback to contractors regarding their profit margins, cash flow, debt structure, and the level of overhead and other costs. The surety team understands that contractors have good and bad years. It is during challenging economic times that the surety professionals look to further strengthen their long-term relationship through open communication.

Sometimes this communication includes difficult advice. In discussing a bond for a particular project or for the expansion of the contractor's bond program, the surety team may recommend cutting overhead and expenses to reduce the contractor's risk of excess costs amid shrinking revenues. At the same time, some contractors may see the down cycle as an opportunity for strategic investment by retaining talented construction professionals who are displaced by struggling construction companies.

Communication may require the surety team to say no to bonding a particular contract or to expanding surety capacity. Certainly this protects the surety company, but the surety team's advice also benefits the contractor's business. Allowing a contractor to take on too much risk threatens the overall viability of the firm. While underwriters and bond producers say the downturn for construction may last until late 2010 or even into 2011, they already are positioning their contractor clients for the recovery. Frank discussion from the surety team will help the contractor insulate its balance sheet and income statement, enhancing prospects for weathering the economic storm and capitalizing on new work opportunities when the construction sector rebounds.

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Preventing Default

The surety team strives to help contractors succeed. After all, contractor default is in no one's best interest. Lenders can be assured that surety companies will do what they can, whenever possible, to help a contractor avoid default. Sometimes, sureties can respond proactively, not just when a contractor defaults on a project.

Surety companies may provide financial assistance directly to a bonded contractor, which enables the contractor to continue its work program, to pay subcontractors and suppliers, and to keep the project moving forward. This assistance may be provided at the contractor's request without involving the project owner and without formal declaration of default.

When the surety becomes aware of a contractor's financial difficulties, it may guarantee a line of bank credit. This action assures a steady flow of materials to the work site and payments to subcontractors. Moreover, the professional expertise of the surety company can minimize problems and losses on a project. Many sureties employ professional engineers, construction attorneys, accountants, and other technical staff or advisers who can help a viable contractor through temporary problems to avoid a default and a bond loss.

When the surety team is kept apprised of problems as they arise, the underwriter and bond producer can be proactive in preventing or averting contractor default.

Claims Process

Sometimes a contractor cannot complete a project and may default if there are drastic financial changes in the economy, unforeseen changes in job-site conditions, cash flow shortages, subcontractor performance issues, or even death or illness of a key employee. Usually, it takes a combination of events to force a contractor into default. When that happens, the professional expertise of the underwriter and producer is there. With the surety team's technical knowledge, practical experience, and resources—and with the cooperation of the contractor and project owner—losses can be minimized and the job completed to the satisfaction of all parties.

As construction lenders face their own credit issues, more are looking to surety bonds as a way to protect their investment in a project.

The surety company has legal obligations to both the project owner and the contractor. First, the surety investigates a claim before taking action in order to protect the contractor's legal recourse in the event of improper declaration of default. On the other hand, the surety must keep in mind its obligations to the project owner. The investigation also serves to inform the surety of the most appropriate remedy in the event of default.

When the surety finds that the contractor is in default and the owner is not in default of the contract, it is obligated to remedy the default in accordance with the conditions, limitations, and understandings contained in the performance bond.

If the surety's investigation finds that the contractor has defaulted on the project under the performance bond, the surety company typically may:

- Take over the project for completion.
- Tender a replacement contractor to the owner to finish the job.
- Retain the original contractor, usually with the consent of the owner, and provide trained personnel and/or financial assistance.
- Reimburse the owner's cost to complete the project (less any contract balances held by the owner).

Typically, the surety's financial liability is limited by the penal sum of the bond.

Value of Surety Bonds

As construction lenders face their own credit issues, more are looking to surety bonds as a way to protect their investment in a project.

Surety prequalification is more important in a difficult economic cycle than during a robust economy. Construction lenders are concerned about investing their money and making sure that risks are managed. Suretyship is one of the ways project owners, lenders, or investors can find protection for the investment they are committing to the construction industry. Sureties have the knowledge in financial analysis and other credit-extension skills to provide the assurance that the project will be completed in accordance with the terms and conditions of the contract and that the subcontractors and suppliers will be paid.

Construction lenders are concerned currently about extending capital on new developments. Requiring performance and payment bonds assists the lender in managing the risks of the construction contract by making certain that a qualified contractor is on the job.

Underwriters and bond producers draw upon years of experience in measuring a contracting company's capabilities. The underwriting analysis includes a thorough review of 1) financial matters; 2) the organization's experience; 3) business succession planning; 4) a contractor's relationship with project owners, subcontractors, and suppliers; and 5) the type and size of construction. But even with these comprehensive underwriting reviews, the dynamic nature of the construction marketplace creates continuing challenges that can push contractors to the brink of failure.

Because construction contractors continue to face dislocation in the credit markets as well as unprecedented economic instability, it is prudent for project owners and financial institutions to rely on the surety's rigorous contractor-prequalification process and the project-completion assurances of surety bonding. ❖

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For more information about surety bonds and the surety claims process, see:

« *Contract Surety Bonds: Protecting Your Investment*

http://www.sio.org/pdf/protectinvest.pdf

« *An Overview of the Contract Surety Bond Claims Process*

http://www.sio.org/pdf/agc_surety_claims_guide.pdf

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