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[NOVEMBER 2009]

Construction

EXECUTIVE

*Annual
Contractors'
Guide to*

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BONDING**

**INCLUDING THE
2010 DIRECTORY OF
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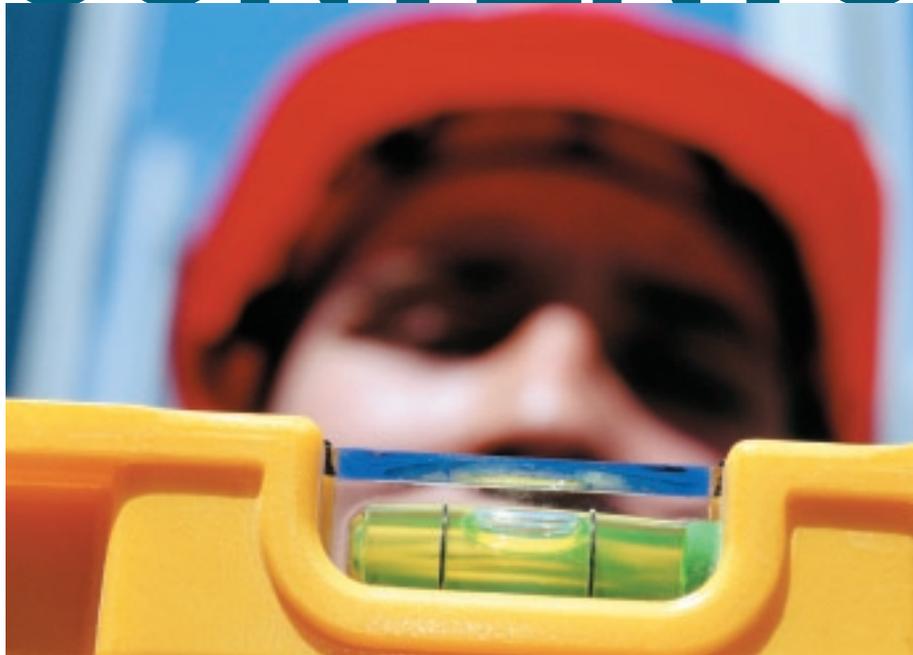
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2009

The slumping U.S. economy was created, in large part, by an irrational and overheated credit market. The implications of the credit crisis are now becoming more evident in the surety industry, which is a central source of credit to the construction industry.

BY MARC RAMSEY

Surety Market Over

Concerned by the current heightened risk environment and exposure to increasing contractor failures, surety companies have not changed underwriting standards, but are more closely scrutinizing contractors to ensure they meet those standards. Underwriters are looking at whether contractors have depleted their cash reserves, rely heavily on the bank, have difficulty right-sizing their company in the down cycle, or are seeking bonding support for projects of greater size or scope than their normal business plan. This level of underwriting scrutiny will remain until the U.S. construction economy demonstrates signs of a real recovery.

The current trend of longer bid lists and declining margins is likely to continue throughout 2010. The efficient management of human resources remains critical to maximizing returns. Solid underwriting requirements will continue, and the most disciplined contractors ultimately will come through this economic cycle as stronger companies with fewer competitors.

HEALTH OF SURETY INDUSTRY

While the surety industry likely will see an uptick in loss ratios in 2009, sureties are well-positioned to mitigate the losses.

In prior underwriting cycles, losses were magnified because the weakened economy was coupled with softer underwriting. Sureties softened their pricing and underwriting to enhance market share. Their books did not consist solely of contractors that were capable of withstanding the downturn.

In the current underwriting cycle, the surety industry has not seen a softening of underwriting. The magnitude of the losses in the early 2000s gave companies an underwriting mantra, and they stuck to the basics. Sureties have remained focused on retaining well-capitalized and well-managed contractors that can face current economic challenges. While losses are likely, they will not be as great due to disciplined underwriting.

Furthermore, the property and casualty insurance industry is well-positioned to withstand these losses. Mortgage-related

INDUSTRY PROVES READY

TO MEET TODAY'S NEEDS

AND TOMORROW'S CHALLENGES

view

investments have affected the financial standing of insurance companies, but indications show the property and casualty insurance industry remains well-capitalized to meet its obligations under policies and bonds.

SURETY CAPACITY

Unlike banks, property and casualty insurers have proved financially sound, so sureties are more willing to provide capacity now than banks. Sureties are competing actively for business and generally have strong financials to back their capacity, which is sufficient to meet the needs of customers in all market segments.

Capacity also is adequate due to the reduction in the overall amount of construction being put in place at this time. Most contractors' backlogs are substantially smaller than in previous years. They are unable to utilize their total surety capacity because sufficient work isn't available.

On the other hand, sureties have raised the level of examination in terms of credit worthiness to extend this capacity. Today, sureties are looking "under the hood" for signs of weakening balance sheets caused by the negative effects of the recession. Sureties are responding to the changing composition of their clients' balance sheets and adjusting program commitments as necessary.

Small: Under \$10 million

This market has been hit by multiple factors, including fierce competition caused by an increased number of bidders on scarce new work, private sector contractors entering the public market, decreased profit margins, increased claims, growth in geographic territory due to a lack of local work, and bank scrutiny on lines of credit and construction loans.

Capacity in the small market is adequate, but requirements for entry remain high for small contractors seeking to obtain the support of a surety partner for projects exceeding a certain size. Smaller firms must demonstrate a certain level of experience and sophistication, and have access to capital to obtain surety support. Without reasonable levels of committed capital, contractors are unlikely to be extended surety credit based on projected earnings and prospective growth of the balance sheet.

The surety industry is committed to enhancing bonding access for small and emerging contractors. Access is less of a

capacity issue than a qualification issue. For example, the public procurement workforce is stretched, and more jobs are being bundled together under much larger contracts. A single contract may be more efficient for the procurement workforce team to administer, but it is not realistic to expect a contractor whose largest project to date is \$1 million to qualify to perform a \$100 million contract. The surety industry also is seeing projects that are supposed to be small business set-asides carry price tags as large as \$50 million to \$100 million.

Occasionally, states propose legislation to waive bonds or increase bond thresholds as a way for small and emerging contractors to access jobs, but these practices may do more harm than good. One of the purposes of a surety bond is to protect the states' and public's interests by assuring a qualified contractor performs a project. This also ensures that subcontractors and workers get paid. Lack of a bond on a project hurts these subcontractors and workers—most often the small and emerging contractors legislators intend to help.

The industry is working with government procurement agencies, public works owners and legislators to find solutions to contract bundling, bond waivers and bond threshold issues. One way the surety industry is making a difference is through implementation of programs to provide small and emerging contractors with education, mentors and technical assistance to address the qualification issue. (See related article, *What Small Contractors Need: Targeted Bonding Assistance and Access to Capital*, p. S36)

Middle: \$10 million–\$100 million

Even with the consolidation of carriers that occurred during the past several years, capacity still is sufficient in the middle market. Carriers are employing greater scrutiny in evaluating these contractors in line with their underwriting requirements, but will expand both single and aggregate programs for what they perceive to be valued accounts.

Some surety executives set the mid-market range at \$50 million to \$150 million. The capital structures, reinsurance arrangements and net retention strategies of many underwriting companies support business plans that focus on developing relationships with construction firms with sales in this range.

Middle market contractors may see some underwriting flexibility from surety companies on issues such as surety rates, geography, capital thresholds and personal guarantees.

Also noteworthy in this market is that some surety carriers that historically have stayed below the \$10 million level appear to be increasing limits in order to participate in this market. Carriers may re-evaluate losing accounts to another underwriter simply because those clients have outgrown internal limits set on capacity.

Large: \$100 million–\$250 million

Although surety competition has increased, the large market has many of the same characteristics as the middle market except at the high end.

Consolidation continues to affect the large construction market, as a recent merger left the surety industry with only a handful of participants. Underwriting continues to be disciplined, and more pressure has been placed on contractors in this market to show how they mitigate risk with their subcontractors.

Financial institutions also have had an effect on credit availability in this market segment. Contractors' profit margins continue to decrease. Because of a lack of work in this area, some large contractors are increasing their territory in search of smaller projects.

Mega: More than \$250 million

Prior to the recent economic change in the construction market, mega-contractors experienced a strong track record of earnings, growing balance sheets and expanding backlogs. The stronger balance sheets and healthier backlogs will help drive mega-firms through the down cycle and enable these companies to maintain staff and be properly positioned for the recovery. In this market, all contractors are experiencing difficulty securing new work, but the declining backlogs have not yet affected the balance sheets of the nation's largest construction companies.

Five major surety companies appear to be the only consistent players in the mega-construction market. Competition does exist, however, as these sureties look to retain their existing customers and attract new customers.

At this size, risk is as much a factor as available surety capacity. Currently, \$750



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million appears to be the largest single project that one surety is willing to bond. However, most sureties in this category do not exceed the \$500 million level. Sureties will look for co-surety arrangements on these mega projects exceeding \$500 million to spread their risk and support the bond needs of mega-contractors.

SUBCONTRACTOR BONDING

The current economic climate has affected the amount of work available, increased price volatility of labor and materials, stretched contractors' cash positions, changed their balance sheets and reduced their ability to turn a profit. Surety executives expect the subcontractor market to be hit hardest by the economic downturn. Defaults already are evident in the subcontractor community, creating significant challenges for general contractors and construction managers.

A healthy subcontracting community is a prerequisite to a healthy general contracting community. Now more than ever, a solid approach to risk management is necessary. There is no substitute for having an independent, financially sound surety company to research and prequalify subcontractors. They know their clients and can determine the health of other projects and previous work far better than a contractor.

Subcontractor performance and payment bonds ensure a surety has prequalified a subcontractor for a particular scope of work and size of project. The surety's guarantee of performance and payment ensures the job will be completed in accordance with all contractual terms and conditions and that all legitimate covered sub-subcontractors, vendors and material suppliers will be paid for work performed or material provided.

General contractors place their own working capital and net worth at risk on every job, and subcontractor default is a risk that must be managed. Surety bonds provide the single best method for most general contractors to protect their balance sheets. They are an inexpensive method of risk transfer that all general contractors and construction managers should consider on all major subcontractor work packages.

SURETY OUTLOOK

How the surety industry performs in the coming months largely will depend on how the construction industry performs. In turn,

Top 10 Writers of Surety—2008*

Company	Direct Premium Written (Millions \$)
Travelers Bond	\$991.6
Liberty Mutual Insurance Group	\$832.8
Zurich Insurance Group	\$482.3
CNA Insurance Group	\$434.3
Chubb & Son Inc.	\$297.3
Hartford Fire & Casualty Group	\$210.6
HCC Surety Group	\$148.8
International Fidelity Insurance Co.	\$118.8
ACE Ltd. Group	\$109.1
Arch Capital Group	\$105.9

*Includes contract and commercial surety

Source: *The Surety & Fidelity Association of America, "Top 100 Writers of Surety Bonds—United States & Territories & Canada," 2008 (Preliminary). Additional information and reports are available for purchase at www.surety.org.*



how the construction industry performs will depend on the recovery of the U.S. economy—and that is difficult to predict.

A number of factors and considerations, such as the federal stimulus package, may help advance some public works projects and other large jobs that are on the drawing board, as well as improve the conditions of state treasuries, available financing and private owner demand for buildings, plants and equipment. All are experiencing an instability that hasn't been seen in decades.

Cycles dictate that there will be recovery, but because of the lag time that preceded the downturn in the construction industry, it could take some time to restore demand. The recovery will require an upturn in consumer confidence and a more stable, predictable credit market.

Surety executives are beginning to see signs of stability in the economic outlook, but the longer range durability of

these conditions remains uncertain. Most surety executives expect limited growth in the U.S. economy through the first half of 2010. The housing market will be a leading indicator as to when the economy will recover, and some predict that is still at least a year away.

The impact of the slowing economy and credit crisis will lead to an increase in contractor defaults in the second half of 2009. Contractor failures are expected to accelerate in 2010 due to declining backlogs, increased competition for fewer new projects, more onerous contracts, compressed margins and higher overhead expenses as a percentage of sales.

Some surety executives say improvement in construction may not be evident until the second half of 2010. Others say that because commercial construction tends to lag behind residential construction by about 18 months, things may not pick up until mid-2011. Others say it could be well into 2011 before the turnaround in construction becomes apparent, noting the private commercial market may not have bottomed out yet.

Despite the current recession and crises in the mortgage and credit industries, the surety industry has proved financially sound and stands ready to support qualified contractors and help them meet the challenges of tomorrow.

Marc Ramsey is the communications manager for The Surety & Fidelity Association of America, Washington, D.C. For more information, call (202) 463-0600 or email mramsey@surety.org.

RAY PITTS, JR.
President
Allied North America
Insurance Brokerage
of Texas, LLC



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TERRY LUKOW

Executive Vice President

Travelers Bond & Financial Products, Construction Services

If properly leveraged, a strategic partnership or relationship with a professional surety agent can provide insight into a much broader marketplace instead of the contractor simply relying on its own experience. A surety should not only have knowledge of the contractor's territory, but also of other territories a contractor could be evaluating.

Last but not least, the surety's ability to strategically advise a contractor on a number of issues—not just financial—may make the contractor more successful. In today's challenging market, information is the key to success.



TIMOTHY MIKOLAJEWSKI

President

Liberty Mutual Surety



ROD WILLIAMS

Executive Vice President and Chief Underwriting Officer

Liberty Mutual Surety
Although signs are showing that the economy may

be stabilizing, the construction industry will continue to face significant challenges. Funding for both public and private construction projects will be constrained as the economy recovers. Contractors will have fewer opportunities to replace their backlog as it runs out, they will face stiffer competition, and new work likely will be at lower profit margins. Suggested strategies to ride out this economic cycle include:

- have a business plan that addresses the potential for declining revenues and margins;
- be prepared to make necessary cuts in overhead;
- manage debt and limit fixed asset purchases;
- carefully consider the risks of venturing outside of past experience into new territories, different types of work, new owners or substantially larger projects;
- beware of onerous contract terms, such as consequential damages provisions; and
- conserve liquidity and limit dependence on credit.

Continued bonding support will be essential. Partnerships between the contractor, surety underwriter and agent are more important than ever. Frequent, open and meaningful dialogue among all parties will minimize surprises. Through consistent and responsible underwriting, an experienced surety company can offer stable surety capacity to help contractors manage the ups and downs of construction cycles.



DAN RIORDAN

President

Zurich North America Surety, Credit and Political Risk

There is no doubt that a professional surety agent or broker and a top-rated surety are two of a

ANALYSIS AND ADVICE FROM SURETY INDUSTRY LEADERS

construction firm's most important business advisors. The 2009 economic climate and credit crunch has raised the risk levels for contractors today. Issues such as the availability of project financing, strenuous banking relationships, onerous contractual terms and subcontractor default have conspired to significantly raise the risk profile for construction firms in a competitive marketplace.

Contractors now need to work more closely than ever with a professional surety agent or broker and a surety provider, which are experienced in helping clients identify and implement solutions for many of these risks. Sureties have seen all sorts of economic cycles (and sometimes have the scars to prove it). These advisors will help a well-managed contractor succeed and grow.



DOUG HINKLE

Chief Underwriting Officer

CNA Surety

Contributing to a contractor's ongoing success is a common interest between

the surety underwriter and the bond producer. The surety benefits from interacting with many different contractors; over time, successful sureties learn to measure and match risk with contractor experience and financial strength. That surety experience is shared with contractor clients through the surety's underwriting requirements.

Recognizing that sureties don't always view the same risk the same way, professional bond producers provide additional counsel through their experience in

working with successful contractors and knowing the difference between the surety companies in the market.

The combined contribution from the surety underwriter and bond producer helps shape an overall business discipline that maximizes surety support and better positions the contractor for long-term success.



MARK C. VONNAHE
*Executive Vice President,
Surety*

Arch Insurance Group

The ability to offer surety to potential customers adds value to a contractor's set of negotiation tools. Differentiating a company is essential to long-term business success.

The underwriting process sureties undertake to establish a contractor's prequalification offers a contractor a rigorous and detailed assessment of its financial stability, credit relationships, business structure, performance history and capacity for new work. Recommendations by the surety agent and surety firm often are based on well-established industry benchmarks, supplemented by their own experiences working with other similar, successful contractors. In today's economy, this third-party review, guidance and prequalification can result in a letter of surety qualification or bid bond, which the owner can use to evaluate a firm's proposal.

The relationship between a contractor and its surety is enhanced over time as the firm successfully develops and grows within the marketplace. This relationship will withstand most trials and setbacks so long as there is open and honest communication between the parties.

Bonds are required on public works projects, but in today's environment, private project owners frequently ask for contractors to be bonded as well. They know the benefit of having a surety prequalify a contractor through a rigorous process.



MICHAEL P. FOSTER
Executive Vice President

Merchants Bonding Company
(Mutual)

Surety underwriters and producers are excellent resources for contractors. They can provide

**It is best to be in a position
to be bondable due to
the severe reduction in the
amount of private work.**

advice on contract language, bond forms and insurance requirements; explain local laws or ordinances that pertain to construction; provide advice on tax planning and continuity arrangements; and help a contractor succeed in business.

A contractor may prefer to perform unbonded work; however, it is best to be in a position to be bondable due to the severe reduction in the amount of private work.

With new submission counts up 26 percent this year, many contractors are attempting to qualify for surety support. This can be a frustrating process for everyone. Contractors should try to get prequalified for bonding so they aren't forced to scramble at the last minute. Not only will they be prequalified for surety support, but they also can take advantage of the other services a qualified surety producer and underwriter can provide.



STEVEN F. COWARD
President

Berkley Surety Group

Demand for surety products may be increasing, but fewer non-bonded contrac-

tors exist today because bonds are available on a secured or collateralized basis. Given the greater availability of surety bonds, more emphasis should be placed on the quality of the surety relationship. Contractors should focus on the benefits derived from surety partners and how they can help when things go wrong.

A significant portion of new business today involves "reconstructive" efforts. The right partners contribute valuable insight when a contractor stumbles and needs surety support to rebuild its company. Truly working together to save a company puts the relationship, experience and knowledge of the surety partners in an entirely different perspective.

Prudent contractors should examine all facets of their surety's operation and also question what happens when claims occur. By and large, the surety's claims functionality today is more sophisticated and responsive than in the past, providing the appropriate expertise in a timely fashion to promote positive and constructive solutions.

MICHAEL F. GREER

Vice President, Surety & Fidelity

Penn National Insurance Co.

Surety bonds are significant to contractors for several reasons; first and foremost is the value of the surety relationship. An expert surety has seen hundreds of contractor operations and financial statements. It has seen good and bad business plans, as well as companies grow and falter. When choosing a surety, a contractor must determine if it is relationship-oriented and provides value-added advice. A surety that is relationship-oriented will not hesitate to guide the contractor in the right direction.

Unbonded contractors never have the benefit of the advice and counsel of their local surety underwriter or bond agent and, as a result, are less likely to be as well managed as a bonded contractor. The surety prequalification process ensures a contractor knows the technical aspects of construction and running a business.

A bonded contractor can be proud of the fact that it passed a surety prequalification process and should sell this fact to project owners, whether it is a bonded project or not.



HENRY W. NOZKO JR.
President

ACSTAR Insurance Co.

The surety bond producer and underwriter are two of the most valuable advisers a contractor can have because they help position a contractor to maximize its bonding capacity, acquire work and steer clear of pitfalls that can lead to default.

In the midst of a down cycle, it is a grave error not to downsize and conserve assets. It makes no sense to operate as usual and hope for a change. The best way to prepare for a recovery is to cut expenses now in order to conserve assets and resources so they are available when conditions

present better opportunities to generate profit. Once the market improves, there will be plenty of time to bulk up.

A contractor also might want to develop a policy of bonding subcontractors to mitigate the cost and disruption caused by a failed subcontractor. Because a bonded subcontractor has been prequalified by a surety, it is less likely that it will fail. In the event it does fail, the contractor has recourse for recovery of damages as a result of the subcontractor bond.

BOND PRODUCERS



TODD LOHNERT

President

National Association of Surety Bond Producers

Senior Vice President, Bond Manager

Wells Fargo Insurance Services of Kentucky

The surety professional's ability to communicate market conditions and review underwriting data with a contractor on a continual basis separates the surety professional from the competition. This interaction between agent/broker and contractor also must include the surety underwriter. Regularly scheduled meetings allow the underwriter and bond professional to better understand the contractor's business philosophy and strategy during prosperous and difficult times. When the surety professional, contractor and surety underwriter are on the same page, the result is a maximum surety program.

A long-term client put it best when describing the importance of his bonding relationship: "I put a lot of time and effort to build my company's balance sheet, based on the advice of key business partners, so that I would have the bonding capacity to separate myself from my competitors."

The choice of a contractor to utilize a professional surety agent/broker to assist in making decisions—such as upgrading internal accounting systems, replacing an accountant with one that is more familiar with construction accounting principals, maintaining profits within the company, or better managing general and administrative expenses—all result in increased opportunities down the road through increased bonding capacity.



The contractors with the strongest bond relationships are the ones that consistently deliver forecasted results.



WILLIAM A. MARINO

Chairman and CEO

Allied North America

Surety historically has been used by project owners to prequalify interested bidders and transfer performance and payment exposures related to construction. When a surety company supports a bid bond, it affirms that as a result of due diligence, the contractor has the necessary financial and technical resources to successfully complete the project. If the surety then issues performance and payment bonds for the project and turns out to be incorrect in its assessment, the surety ultimately will be responsible for fulfilling the obligations of the contract, such as completing the corresponding scope of work and paying all covered subcontractors and suppliers up to the amount of the bonds.

The surety underwriting process is relatively simple. Surety underwriters request historical financial and project-related information from their clients as well as

make projections regarding future performance, and then measure these projections against actual performance. The contractors with the strongest bond relationships are the ones that consistently deliver forecasted results.



MICHAEL J. CUSACK

**Senior Vice President,
Managing Director and
Operations Board Member**
Aon Construction Services
Group

In today's marketplace, only well-managed, well-capitalized firms have access to significant bonding capacity. The ability to bond work in a tighter credit cycle confirms that a contractor has the financial, technical and personnel resources needed to complete a project successfully.

Surety affirmation is a line of demarcation between the ordinary and the strongest construction firms. Stronger construction companies take pride in their surety credit relationship, often advertising their bonding capability as a testament to their success over the years. Conversely, thinly capitalized companies or struggling franchises are more inclined to attempt to convince owners and obligees that bonds are an unnecessary expense, and that the multiple risks of the construction process can be managed simply by bonding subcontractors or insuring against subcontractor defaults.



FRANK C. RODDEY

**Senior Vice President,
Surety Manager**

Rutherford

When working with surety brokers, contractors can increase market share and gain access to new markets such as the public sector, public-private partnerships and green building—all of which result in increased revenue and profit. In difficult economic times, it is imperative that a contractor has a professional surety broker with the technical expertise and experience to maximize the surety program.

The challenges of the current economy include frozen credit markets, a scarcity of work, difficulty getting paid, increased competition with lower hit ratios and volatility in material pricing. To survive in this environment, a contractor must thoroughly



A RESPONSIVE, FLEXIBLE SURETY SOLUTION HELPS KEEP A CONTRACTOR WORKING

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When a large contractor bidding mega projects lost confidence in one of its sureties, they contacted us. Working across holidays and weekends, our surety experts moved quickly to assess the projects and the contractor's ability to perform the work. Within four days from our first meeting with the contractor to bid time, we developed a workable bonding solution agreeable to all parties. The bottom line is our responsive, flexible solutions help contractors succeed. For more information, contact your independent agent or broker or visit www.libertymutualsurety.com.



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investigate and confirm that the project owner has sufficient financing to complete the project without restrictions.

Contractors can maximize their bond programs by developing new markets that will broaden their customer base. Contractors also should use this time to manage their firms' key financial ratios, improve receivable collection policies, eliminate unproductive employees, reduce overhead, and negotiate favorable contract and payment terms. The main objective should be to remain competitive and preserve bottom line profits for the better days ahead.

All of this, coupled with meaningful and frequent communication with a surety broker and other advisers, will aid in planning and ward off problems before they develop.



MIKE SPECHT

Vice President

Minard-Ames Insurance Services (Member of INSURICA Insurance Management Network)

Surety partners can help contractors maximize their pipeline of potential projects and better understand their financial health, which is even more critical in today's economic environment.

Sureties have more than 100 years of experience prequalifying contractors and establishing financial benchmarks used in the underwriting process. Sureties compare their customers' liquidity, leverage, and activity and profitability ratios to benchmarks to help determine how much surety to extend. Contractors benefit by comparing their key ratios to the surety's stringent benchmarks.

Being prequalified for bonding allows contractors to pursue public projects, as well as private jobs for which the owner or lender has required the protection of a bond. For subcontractors, establishing bonding greatly enhances their ability to meet the general contractor's prequalification standards and be selected for the project team. During an economic downturn, no one can afford to be handcuffed by an inability to pursue bonded projects.

The ability to obtain contract surety bonds opens doors to projects that non-bonded contractors can't pursue. In addition, going through the surety's prequalification process helps contractors better understand their financial health.

During an economic downturn, no one can afford to be handcuffed by an inability to pursue bonded projects.

ADVISERS

HERB BROWNETT

Senior Vice President

Textura Corporation

The ability for construction owners to mitigate general contractor risk and general contractors to mitigate subcontractor risk via payment and performance bonds is a financial cornerstone of the industry. Good contractors know their bonding capacity is a valuable asset for getting new work.

There are three keys to a contractor's ability to increase its bonding line. First is a good bond agent who has a strong working relationship with both the contractor and the surety underwriter. Second is a surety underwriter who clearly understands both the economics of the industry and the unique nature of the individual contractor. Third is risk management technology that can be leveraged to benefit all the parties. Collaborative technology solutions ensure accurate billings and payments, lien waiver collection, document compliance and strong prequalification management—a great benefit to surety professionals and contractors alike.

JAMES F. ARCHIBALD III

Partner

Bradley Arant

Major state and federal construction projects usually are available only to bonded contractors that can provide performance bonds to protect taxpayers against the risk of default and payment bonds to protect subcontractors that do not have lien rights against public property.

While the recession has reduced the number of private construction projects, public projects—including highways and bridges, public housing, courthouses,

office buildings, military bases, embassies and consulates, prisons, hospitals and medical facilities, water treatment plants and schools—remain plentiful. Without bonding capacity, opportunities to bid on and perform these kinds of projects are out of reach.

Because of the recession, many contractors that historically focused on private construction work have altered their business plans to seek public work. Surety advisers have been able to help these contractors understand some of the unique legal challenges presented by public work. Likewise, surety underwriters and bond producers with experience bonding public work can help contractors understand some of the financial risks associated with making the switch.



DAVID ALLISON

Construction Practice

Leader, Midwest Region

CBIZ & Mayer Hoffman McCann P.C.

The bar has been raised for entrance into the competitive bidding game of the construction industry. In the past few years, most contractors have been able to select customers and negotiate pricing with owners, but those days are gone. Now, contractors must separate themselves from the pack, and that differentiator is being bondable.

CPAs specializing in the construction industry see the bottom-line difference between contractors that can provide a surety bond and those that cannot. Contractors without bonding capacity must compete for access to the equipment and manpower to perform the work, sometimes without the experience or financial ability to complete the project.

A bondable contractor has the advantage of competing with other contractors that are financially sound and able to perform great work. These competitors all understand that "profit" is not a dirty word—it is a common objective of all strong companies. This exclusive club of contractors understands costs and how to make money—even in a down economy.

Compiled by The Surety & Fidelity Association of America, Washington, D.C. For more information, call (202) 463-0600 or email mramsey@surety.org.

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STRESS TESTING

A Contractor's Balance Sheet

BY MARK REAGAN

The last two years have exposed remarkable stress levels in the economy—from global institutions to local builders—and the construction industry has been especially hard hit.

While many contractors enjoyed healthy backlogs and margins as the economy faltered, the decline in new

residential and commercial projects has reduced new work, increased competition and placed pressure on construction

operations in all sectors throughout the country.

At some point—probably sooner than later—all of these factors will affect the profitability and financial strength reflected in contractors' balance sheets.

Construction accounting has represented as much art as science since the introduction of percentage of completion reporting. Until the move from completed contract methodology to percentage of completion, the quality of a balance sheet could only be gauged by looking at cash, debt and historical trends. Balance sheets looked to be dramatically undercapitalized because no profits were being reflected until final completion of the contract. For credit grantors, including banks, sureties and vendors, financial analysis involved looking only at the results from completed work. The impact of ongoing work and profitability in the backlog was as much about educated guesses as true detailed analysis of the balance sheet.

THE DANGER OF ESTIMATES

Though helpful, today's evolved reporting tools present a real danger to making the best credit decisions on continuing projects. Revenues on projects in progress combine cost to date and an estimate of the profit earned on those costs. While the cost to date should be known if the accounting systems being used are accurate, the estimates of cost to complete, final contract price to be billed and the resulting

profit at completion are merely estimates.

If any issues surround the estimated cost at completion and the potential for variances on the final amount to be billed and paid, then those numbers are in flux. In construction, it is rare to know final numbers until a project is nearing completion. To the extent there are weaknesses in the reporting systems, the potential for impacting the balance sheet is magnified. Even if no doubts exist about the quality of the reporting, it is still imperative that the balance sheet be re-examined to establish the extent to which both liquidity and equity

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are driven by estimated costs and profits.

For example, if a \$1 million project is projected to make a margin of 10 percent or \$100,000, and the costs to date at the close of a financial reporting period total \$450,000 (half of the total estimated cost of \$900,000), then the costs and estimated earnings to date (\$50,000) would be \$500,000. Depending on the amount billed to that date, the balance sheet would reflect an under- or over-billing as either an asset or a liability. The capital would reflect the estimated profit at that date of \$50,000 before overhead, depreciation and taxes.

The important point is that an estimate of final cost, billing and profit is in the equity. If the costs exceed the estimate and the profit recognized at the interim stage was inflated, then the project makes only \$50,000 at completion and the financial report (based on the earlier estimates) overstated working capital and equity by \$25,000.

Given that the statements of many contracts reflect substantial amounts of estimates of both costs and related profits, there is always the possibility of a shock loss if job profits fade and the earlier estimates are restated. This is the inherent "stress" in a contractor's balance sheet.

THE WEIGHT OF WORK-IN-PROGRESS

Contractor operating results typically are driven by a handful of larger projects at various stages of completion. Depending on a few projects to carry the enterprise places particular emphasis on the accuracy of reporting interim results on those projects. If this handful of larger jobs reflects, in the aggregate, a significant proportionate share of the earned profits being reported in any balance sheet, it is likely that the financial capacity of the firm is tied up in those projects.

It is not uncommon to analyze a balance sheet and find the earned profits on the larger projects in progress represent the strength in the balance sheet. At times, analysis shows the earned profits exceed the working capital—and sometimes the equity—of the contractor. The implications to any credit grantor are clear. They are extending credit on cost and profit estimates.

The implications for contractors are even more critical. As they look to deploy their assets in running and growing their businesses, they need to understand that the foundation of their financial position might be centered in their most current work. The cash on hand may be a function

of billing ahead of both their costs and profits. This base may be less certain than the cash resulting from completed projects. Decision-making regarding new work, expansion, equipment purchases and additional staffing may be based on assumptions that relate back to assumptions on the open projects.

While all contractors have some degree of work-in-progress profits in their balance sheets, the more prudent decision-makers continuously stress test their financials. Prudent credit grantors also understand the impact of not yet completed profit recognition when making lending decisions.

With extra pressure on contractors coming from the broader economic climate, a disciplined effort to identify the degree that a balance sheet relies on the work-in-progress estimates can provide valuable insight into financial stress and strength. This insight then can better inform strategic thinking and decision-making by contractors and their surety and banking partners.

Mark Reagan is managing director for Aon Construction Services Group. For more information, call (973) 463-6003 or email mark_reagan@ars.aon.com.

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BIM - NEW RISKS In Construction

BY LARRY TAYLOR

In 2004, the National Institute of Standards and Technology reported the construction industry was losing \$15.8 billion per year because of poor interoperability and data management, and deemed building information modeling (BIM) the answer to this costly problem. BIM makes the building process a collaborative effort between design and construction by allowing project teams to visualize the structure, create efficiencies and cut down on costly project changes.

But for all of its benefits, BIM also is blurring the lines between design and construction, creating anxiety and unintended consequences in an industry that is as much about managing risks as it is about designing and constructing.

WAKE-UP CALL

During the National Association of Surety Bond Producers' national conference in April, a 30-year veteran of the construction industry explained how he had a BIM wake-up call. During a panel discussion, he said his company, as the client's preferred contractor, expected to win a \$2 million interior project for a data center. The company came in with the low bid and had two professional recommendations. The client, however, selected another contractor that offered BIM.

It was a relatively small contract, but the contractor predicted that situations like this would happen more often, throwing the construction, surety and insurance industries for a loop. These industries were comfortable with the way risk, roles and responsibilities were assigned in agreements. Contractors, surety bond producers and insurance underwriters knew the clauses and provisions sometimes verbatim—but with BIM, they are struggling to state clearly who is responsible for what.



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In the traditional model, the client hired an architect to create a visual plan and then took it to the market for bids. Recent trends toward design-build contracts improved project efficiency and, in theory, decreased the number of disputes between the designer and the builder.

Now, contractors are moving toward BIM, in part because of the benefits for the subcontractor community. BIM allows subcontractors to be more efficient in material ordering, prefabrication and other areas. Contractors that have adopted BIM are using it to model virtually every job, putting them in a role with new responsibilities and risks not likely addressed in standard contracts.

SURETY BOND CONVERSATIONS

Before determining the terms and conditions that ultimately end up in the performance bond, construction companies and bond producers should include their surety underwriter in a discussion about the following observations:

- Subcontractors using BIM often create the conceptual plans and enter all the information needed for this type of modeling.
- With BIM, typical top-down organiza-

Just as BIM promotes collaboration between design and construction, it also should promote a collaborative effort among contractors, bond producers and surety underwriters.

tion charts don't work because it is a collaborative effort, and roles and responsibilities become less clear. To be successful, the entire project team must be included: the owner, engineers, consultants, general contractor/construction manager and specialty contractors.

The team also should discuss the following questions:

- How will this impact existing risk management practices?
- What risks might be assumed, knowingly or unknowingly, in a BIM team approach?
- Will related risks, such as standards of care,

ownership of documents, costs of new hardware and software, and responsibilities for project communications be accounted for in the prime contract and in the subcontracts?

- Are existing insurance policies and surety bond forms sufficient for a design and construction environment using BIM or related technologies?
- If an architect or a contractor chooses to use a blanket BIM disclaimer, what kind of message does that send to the other team members?
- Does BIM change any expectations regarding short-term and long-term building functionality?

Just as BIM promotes collaboration between design and construction, it also should promote a collaborative effort among contractors, bond producers and surety underwriters. Consulting with the surety bonding team is critical to an organization's successful implementation of BIM.

Larry Taylor is president of Merchants Bonding Company and past chairman of the National Association of Independent Sureties. For more information, call (515) 243-8171 or email ltaylor@merchantsbonding.com.

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RISK MANAGEMENT AND INSURANCE PROFESSIONALS

Best Practices for Managing Today's Risky Environment

BY DAN RIORDAN

In this challenging economic market, well-managed construction firms have increased their focus on robust risk management practices to better manage costs and increase profit margins. Enhanced risk management efforts are no longer just “nice to do,” they are “must do” best practices.

PROJECT FINANCING

Contractors are focusing more than ever on project financing. In today's credit crunch, a contractor must fully investigate the source of funding for a project. Before a firm incurs costs and commits resources, many questions need to be answered.

- Is the project financing in place, and what is its source? These questions have been routinely important for jobs in the private sector, but how they extend to public work is vital as well. Many projects are subject to funding from the sale of bonds, and the credit crisis has made that source more problematic than in prior cycles. Tax revenues have declined, so investors have reduced their commitments.
- Are there contingencies to the financing? Some project funding is subject to contingencies, which must be fully understood ahead of time. For example, one construction client was engaged in work for a retirement community, but the financing for the work was contingent on the presale of a certain percentage of the units. When sales activity slowed, financing was withdrawn.
- Is the financing in place for the entire project or just for a phase of the work? If a contractor gears up for 100 percent of a project, but financing is only available for a portion of the work, a severe mismatch occurs that can be detrimental to the contractor's finances.

CONTRACTOR FINANCING

Having a relationship with a sound, committed construction-oriented bank

is crucial to maintaining cash flow and financial stability. With exposures to bad real estate loans, sub-prime mortgages and other non-performing assets, the financial condition of many banks has deteriorated. Prudent risk management calls for a thorough understanding of a bank's financial strength to be sure it can perform when needed. Many experts agree that establishing a backup banking relationship is important for construction firms.

Additionally, many banks that were active in the construction market reduced their exposure to contractor lending. Some contractors report their banks are imposing stricter loan covenants in terms of current ratio, debt to equity ratios or other measures. Contractors should develop a close relationship with their banker so the bank can be an advocate in the lending process.

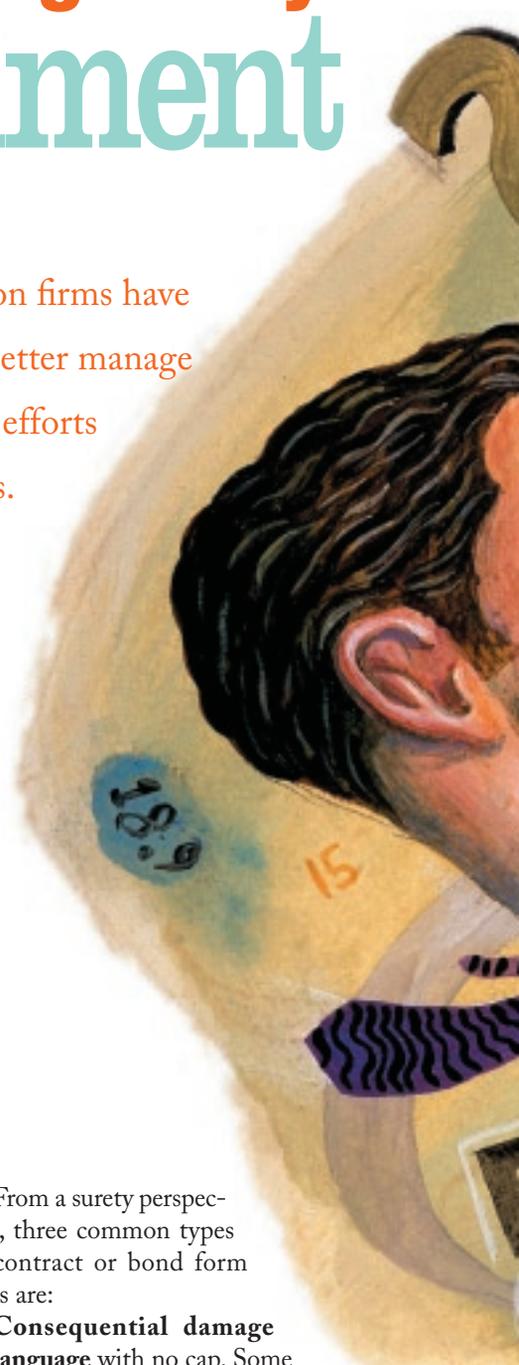
CONTRACT REVIEW

Another industry best practice is the establishment and utilization of a formal contract review process. The legal review of contract terms is either carried out in house through counsel and staff or through the use of outside counsel.

The contractor puts its own working capital and net worth at risk every day with every contract, and the surety puts its capacity at risk by writing surety bonds for the contractor. Overall, the risks the contractor assumes through the contract with the owner should be reasonable and fully recognized by all parties.

From a surety perspective, three common types of contract or bond form risks are:

1. **Consequential damage language** with no cap. Some contracts may have the effect of consequential damages without actually using the term “consequential.” Unlimited consequential damages place the contractor at great risk and, without a cap, can create risks in excess of what is planned. A sound remedy is to insist on language that acts as a mutual waiver of consequential damages.
2. **“On demand” language** requires the surety to pay monies to the obligee upon its demand for any and all fees expended by the owner on account of





the failure and/or refusal of the contractor to perform and/or comply with the terms and provisions of the contract. This could be applied even if there was no declaration of default.

3. **Indemnification language** in the bond form expands the liability of the surety beyond that of its principal. Some bond forms have broad indemnification language covering any and all losses, liability

and damages, claims, judgments, stop notices, costs and fees, whether imposed by law or equity, that may be incurred by the obligee by reason of the failure or default on the part of the principal. This language is broad enough to imply tort liability and other risks the contractor or the surety never intends to cover under its performance and payment bonds.

Contractors must utilize these and other strategies to succeed in today's high-risk environment. Talk with a professional surety agent, legal counsel and accountant to craft an effective risk management strategy.

Dan Riordan is president of Zurich Surety, Credit and Political Risk. For more information, email daniel.riordan@zurich.com.

Keep the Surety in the Communication Loop

BY JOHN COYNE

Difficult times can bring out some of the best management instincts, especially as construction professionals shift into survival mode and re-examine longstanding processes. In doing so, they often streamline overly expensive processes and eliminate antiquated ones to come out with a more efficient organization.

However, during all of this self-examination, it is easy to forget that the construction executive exists in a much larger world—a world of creditors and business associates who, without hearing from the construction firm, are left wondering how the organization is coping with the stresses of a recession.

Anxious times such as these call for heightened communication with all of the interested parties connected to a construction business, such as its banker, subcontractors, employees and surety.

THE HERMIT MENTALITY

Communication often is the first casualty during an economic downturn. When times are good and business is growing, business professionals naturally find it easier and more pleasant to let others know of their success, goals and strategies. In tough times, they are not as determined to share information. Managers may become more introverted in hopes that the difficult time will pass quickly. If the financial statement has taken a beating, they may feel inclined to not draw any attention to the situation lest anyone ask questions or begin to view the firm in an unfavorable light.

However, putting communication skills into cold storage until the economic



landscape improves likely will be counterproductive and could lead to lasting damage.

WHO TO BRING TO THE TABLE

Construction managers should be proactive and reach out to keep interested parties in the loop. Bankers need to know about cash flow and a contractor's ability to repay loans. Suppliers need to understand when they will be paid for materials and why payments might be slower. Subcontractors that have been loyal partners need to understand the business plan and

whether bidding may pick up so they, too, can plan more effectively.

The surety is an equally important part of the communication loop. The professional surety is a key stakeholder that can help a construction company grow or help keep it in business. Surety bonds protect creditors against numerous risks facing a construction project, and a surety can provide protection for bid, performance and payment bonds, licenses and permits, release of liens and supplies.

It is especially important during tough times to communicate clearly, through an agent or broker, the state of the construction firm's financial health and any unusually difficult financial or technical issues facing the business. A good surety has resources in the legal, financial and accounting arenas.

A professional surety should be a true partner. Construction project managers should feel comfortable discussing project issues in detail. By disclosing problems to the surety, they can tap the surety's resources to address the issue. An experienced surety will not automatically rescind bond credit upon hearing negative news, but rather will work with the firm to get the project back on track. Just as many construction executives have met the challenge of difficult times and weathered the highs and lows of business cycles, so have many bond underwriters.

Presenting bad information and seeking the surety's input is always better than sitting on a problem and then surprising everyone with a poor fiscal statement.

Finally, ensure employees understand management's thoughts about the future of the business and where they fit into the strategy. During downturns, it is not uncommon for staffing levels to fluctuate. Poor communication of the vision can lead to a dispirited workforce.

In this economy, managers in the construction industry must fight the instinct to "go it alone." They must engage all of their stakeholders, including the surety, and clearly articulate cogent strategies designed to see them through to the inevitable upturn.

John Coyne is vice president of Construction Services for Travelers Bond & Financial Products. For more information, call (267) 675-3134 or email jcoyne@travelers.com.

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Maximizing Bonding Capacity in **TOUGH** Economic Times

BY WILLIAM P. WATERS

When new construction work is scarce and project funding is tough to come by, the last thing a contractor wants to do is disrupt its surety bonding program. A firm's focus needs to be on maximizing the surety program and avoiding any actions that would limit its support in any way. Understanding what the bonding company needs and how the underwriter thinks is critical to maximizing a bonding program.

ESTABLISHING STRONG PARTNERSHIPS

Most disruptions in bonding support stem from a breakdown in communication. For a surety to have the confidence to support a business plan, it needs to know where the company has been, where it's going and how it plans to get there.

The pursuit of larger projects, new geographic territories and other types of work have become common strategies as contractors look for the work and revenue they need to maintain their operations. Sureties don't like surprises, so if a firm plans on venturing outside its niche, it needs to share that information with the surety to gain buy-in. Two days before bidding is not the ideal time to tell the surety that the company wants to shift its focus from retail work to wastewater treatment plants.

A major component of the surety's underwriting process is the analysis of a contractor's financial condition—and most importantly its liquidity. Any situations that adversely affect liquidity will have a reciprocal effect on the surety program. Many events that affect liquidity are beyond a contractor's control, such as



a hung receivable, a decline in investment values or a constriction of bank lines of credit. But intentional decisions by the contractor can have the same effect.

While using cash to make investments outside the firm's core construction business, loaning money to an affiliated company, paying dividends to stockholders or repurchasing stock might be sound business strategies, it is wise to communicate

these intentions to the surety in advance to determine if they will negatively impact the bonding program.

Given the surety's reliance on a company's financial statements in determining the amount of bonding support to extend, now is not the time to limit the quality or quantity of financial information provided. It might be tempting to save money by skipping an audit or eliminating the CPA-prepared six-month financial statement, but the impact on bonding could be negative.

In addition, contractors must provide timely financial reporting to the surety. The old saying that "no news is bad news" is part of the underwriter's mantra. The faster a surety receives financials, the better—even if the news isn't positive.

OTHER CONSIDERATIONS

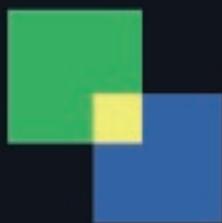
The two most common causes of losses for general contractors are subcontractor failures and the inability to collect from the project owner. Now more than ever, contractors must be diligent in mitigating the risk of subcontractor failure through careful screening of subcontractors and, when appropriate, requiring bonding or other means of financial protection. Also, contractors must refuse to start work until project financing is confirmed.

Contractors should determine how to handle subcontractor/supplier claims or performance complaints from the owner. Designate a point person within the organization to handle communication with the surety company's claim personnel. Complaint letters are becoming more frequent as potential claimants more proactively protect their rights under the bond, so it is imperative to quickly respond to any of the surety's inquiries. Surety claim personnel also can be a great source of information on how best to handle disputes and protect a firm's interests.

Finally, expand the surety relationship beyond the local representative. A strong relationship with local personnel is vital, but getting to know the regional or home office underwriters can add a depth to the relationship that will pay dividends when a unique job opportunity comes along that requires the surety to stretch its commitment.

William P. Waters is senior vice president of CNA Surety. For more information, email william.waters@cnaSurety.com.

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What a Difference a CPA Makes

BY EMILIO F. ALVAREZ

A serious list of challenges faces construction firms today: reduced backlogs, new projects that never get off the ground because of financing issues, too many contractors responding to bids, bids that come in 20 percent below cost, and difficulty in collecting retainages because the lender stopped funding.

A good construction CPA can help contractors overcome these adversities and assist in the surety underwriting process.

A contractor seeking surety credit must be able to provide the surety with timely financial statements that contain all the pertinent financial data about the company. The ability to produce accurate financial information demonstrates that a contractor is in control of the company. A CPA that understands the construction industry can ensure the financial statements are prepared correctly and contain all the disclosures the surety needs to make sound credit granting decisions.

At underwriting meetings between the surety and the contractor, a CPA can ease the process of analyzing the financial statements by explaining issues such as under-billing on a specific project, the company's approach to estimating, or the treatment of costs incurred on unapproved change orders and claim revenues.

Successful contractors know that it makes good business sense to treat their surety as a partner, and quality construction CPAs support this arrangement. If a CPA takes a contractor client down a path of excessive profit distributions and

incomplete financial statement disclosures to the detriment of the surety, it is doing a disservice to its client even though it may sound attractive to the contractor.

CPAs AND CASH FLOW PROJECTIONS

Although profitability is the ultimate measure of success for a contractor, it is equally vital to maintain a close relationship between profitability and cash flow. Often, a profitable company that pays no attention to its cash flow will fail faster than a less profitable company that makes cash flow a high priority.

As a result of the economic downturn, contractors are experiencing difficulty collecting receivables, as well as seeing lines of credit reduced or canceled by banks. A CPA can assist clients by improving internal control functions, developing internal reports that monitor and project cash flow needs, streamlining the billing process to accelerate collection, and maintaining a closer relationship between the costs incurred and the contractor's billings.

Monitoring the costs incurred on projects and controlling spending are of paramount importance in managing cash flow. A CPA should get involved by helping the

contractor produce cash flow reports by project, by project manager and for the company as a whole, as well as committed cost reports and estimated-to-actual comparisons.

A good construction CPA can help a contractor make the tough decision to settle for less than 100 cents on the dollar when a receivable appears to be in serious doubt. Contractors, as a rule, find it difficult to accept less than they deserve for work they performed and completed on time.

WORKING CAPITAL

One of the most important items in a contractor's balance sheet and the driving force behind surety capacity is working capital: the amount of capital that is left over after the company has realized its current assets and paid its current liabilities, such as payroll. A multiple of working capital is usually the amount of capacity a surety is willing to extend to a contractor.

A good construction CPA makes it a priority to help a contractor institute a discipline of capital retention and negotiate debt in a way that least impacts the working capital.

Given the importance of cash flow, CPAs also can help contractors with tax planning. Several different methods of revenue recognition are available to contractors depending on the kind of work they perform and their volume of annual revenue. These methods may allow the payment of taxes to be postponed, which has temporary cash flow advantages.

CPA firms with many construction clients have the resources to understand industry best practices and can share that knowledge with their clients. These firms have expertise on issues such as equipment acquisitions, the pitfalls of cost shifting, the need for sound internal control structures and the discipline to understand the next job may not materialize.

Construction CPAs don't always tell contractors what they want to hear, but they do produce accurate financial statements with the full knowledge that multi-million dollar decisions largely will be based on the information they provide.

Emilio F. Alvarez is president and managing director of E. F. Alvarez & Company, P.A., Miami. For more information, call (800) 272-5332 or email ealvarez@efacpa.com.



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The Advantages of Consensus-Developed Standardized Agreements

BY MARK H. McCALLUM AND ROBERT J. DUKE

Experienced construction professionals know their industry is fragmented and composed of diverse and often competing interests. Successful projects, however, are characterized by team members who realize they must align their interests to achieve the desired outcome.

Aligning interests for successful outcomes is a fundamental tenet of ConsensusDOCS, an initiative to develop standardized construction agreements being spearheaded by a coalition of more than 20 leading construction associations. These stakeholders collectively represent public and private owners, contractors, subcontractors, suppliers, designers, sureties and bond producers.

ConsensusDOCS seeks to benefit the risk environment of the construction industry by developing and publishing standardized forms that address risks and



ConsensusDOCS 300: Setting the Contractual Underpinnings Of Collaborative Project Environments

A recently published standardized form, ConsensusDOCS 300, promises to make many project participants rethink their roles on construction projects. It establishes the expectations for a collaborative project environment up-front. The principal parties must form a project management group focused on collaborative decision-making and communication. The owner, the design professional and the contractor are all represented in the management group, which strives to reach decisions “in the best interests of the project” through consensus.

One advantage is that key trade contractors, at the discretion of the management group, can be consulted during the early stages of design and participate in preconstruction.

Moreover, the principal parties have the opportunity to share the risks and rewards of the project by establishing a financial incentive program. For example, the project parties may agree to release one another from the results of project decisions made collaboratively by selecting a “safe harbor” decision-making policy.

Lean construction principles—aligned interests, expansive communication, transparent decision-making and thorough planning—are evident throughout the structure of ConsensusDOCS 300.

ConsensusDOCS 300 anticipates that the parties may exchange documents and data electronically by providing an electronic communications protocol. It also lays the foundation for the parties to use building information modeling.

Next on the ConsensusDOCS “change” agenda: a standardized addendum for green building requirements.

responsibilities in the “best interests of the project,” not solely in the best interests of a single party. The ConsensusDOCS coalition advocates that the “doors” of its document development process are open to all organizations and constituencies. The drafting process ensures any constituency with a stake in the development of a specific form has the opportunity to have a meaningful voice, regardless of whether that constituency is a formal member of the coalition.

ConsensusDOCS publishes a comprehensive library of more than 90 standardized forms that cover the main delivery approaches, such as design-bid-build, construction management and design-build. The library also includes coordinated design agreements and subsidiary forms, such as payment applications and change order forms. Further, ConsensusDOCS publishes the most extensive set of standardized bond forms available for private work.

USER BENEFITS

Adoption of ConsensusDOCS forms as preferred contract forms may return significant dividends to users, such as increasing the pool of qualified contractors, reducing or eliminating an adversarial environment, fostering positive relationships, avoiding time and cost contingencies to cover unreasonable or misallocated risks, and enhancing the project owner’s business reputation in the construction community. These dividends may translate into reduced total project costs, a lower incidence of project disputes and a shortened project delivery time.

Attributes of ConsensusDOCS forms that set them apart from other standardized forms include:

- integrating agreement forms with general conditions in one document with dispute provisions;
- placing provisions characterizing the relationship of the parties in one section at the beginning of the document;
- assuming the project owner will be an active, not passive, project participant;
- forging a close working relationship between the project owner and the contractor, particularly with respect to project communications and decision-making;
- removing the design professional as the initial decision-maker/arbitrator of disputes between the project owner and the contractor;

Use of accepted industry standard form agreements like ConsensusDOCS provides assurance to other key project parties, such as sureties, subcontractors and suppliers, that the provisions are fair and balanced.

- preserving, when possible, as much autonomy for project parties to develop their own early solutions to disputes, such as step negotiations and mediation; and
- ensuring multi-party proceedings to preserve the efficiency of the process and the consistency of results.

Use of accepted industry standard form agreements like ConsensusDOCS provides assurance to other key project parties, such as sureties, subcontractors and suppliers, that the provisions are fair and balanced, and do not pose an unreasonable assumption of risk for the prime contractor and downstream parties. Moreover, standard forms contain provisions familiar to insurers and sureties, which facilitates the underwriting processes for critical insurance policies and surety bonds.

Contracting parties, however, should retain knowledgeable legal counsel to review the form contract to ensure all terms and conditions are appropriate to the needs of the parties and are enforceable in the specific jurisdiction of the project.

Simply put, ConsensusDOCS is a unique effort that follows a tried and true model for construction projects—communicating and aligning party interests to achieve successful results. For more information about ConsensusDOCS and a listing of all available standardized forms, visit www.consensusdocs.org.

Mark H. McCallum is general counsel and director of government relations for the National Association of Surety Bond Producers, and Robert J. Duke is director of underwriting and assistant counsel for The Surety & Fidelity Association of America. For more information, email mmcallum@nasbp.org or rduke@surety.org.

Bond Waivers Hurt More than Help In a **Bad** Economy



BY LENORE MAREMA

This year, the U.S. Senate discussed a provision to waive surety bonds for any public project funded by the economic stimulus package. Shortly thereafter, the Oregon Department of Administrative Services adopted temporary emergency procurement rules that permitted state procurement officers to waive performance bond or payment bond requirements for projects funded under the 2009 “Go Oregon!” economic stimulus package. The temporary rules expired in August, and legislation that would have extended the emergency rules until January 2012 was defeated later in the session.

In New York, legislation was introduced late in the session that would have created a small business mentoring program under which the Metropolitan Transportation Authority (MTA) would have been able to waive many state procurement requirements. Small businesses would have partnered with MTA-selected construction manager mentors for four years, during which time the team could have been awarded MTA public works projects costing \$1 million or less. The MTA would have been permitted to waive requirements for bid, performance and payment bonds; competitive bidding; awards to the lowest responsible bidder; and the anti-directed insurance and surety provisions for small businesses participating in this mentoring program. In the first year, the aggregate amount of contracts let under this program could not be less than \$10 million or more than \$100 million. The legislation was defeated in the New York Senate.

However, Ohio successfully enacted a bond waiver program as part of its state budget that allows contractors to perform

As the economy begins its slow recovery, contractors are looking for work to keep their businesses going, their workers employed and their equipment fully utilized. In particular, contractors have their eye on the public projects being funded through the \$787 billion economic stimulus that Congress passed earlier this year. In some cases, these contractors previously worked in the residential construction market and are seeking public work for the first time.

Legislators at the state and federal level have tried to pass laws to help small and emerging contractors win public jobs

in the current economy by waiving the bonding and other requirements for public procurement.



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four state projects without bonding. The first contract for a project done without bonding may be \$25,000 or less, after which a contractor can obtain a contract of up to \$50,000 without providing the bonds required by law. The third contract without bonding is for a project up to \$100,000, and the fourth is for a project up to \$300,000. The bond amounts for unbonded work for contracts with local governmental entities are \$25,000, \$50,000, \$100,000 and \$200,000. Contractors must participate in a contractor assistance program for the first two unbonded projects and must have successfully completed

such a program to obtain the last two unbonded projects. A contractor must successfully complete one unbonded job to be awarded another one.

THE PROBLEM: TAXPAYERS PAY THE PRICE

Although well-intended, these legislative efforts could hurt more than help contractors and taxpayers. Because mechanics liens cannot be asserted against public property, laborers, subcontractors and suppliers on public projects must rely on the general contractor's payment bond for protection.

If this bond is waived, these parties have no way to collect for their services

and supplies if the contractor is unable or unwilling to pay them. Small and emerging contractors are more likely to start as subcontractors. If no bonds are in place, subcontractors and suppliers either have to risk losses from nonpayment that they cannot afford, or not work on the public jobs for which they are qualified.

In the current economy, contractors must have payment protection.

The performance bond ensures the project is completed with the state and local taxpayers paying only the contract price. If a performance bond is not provided, the taxpayers take on the risk that

What Small Contractors Need: Targeted Bonding Assistance and Access to Capital

By Sam Carradine

Small and emerging contractors historically have had difficulty obtaining bonding on public projects, but this challenge is being met through contractors' increased awareness of bond readiness requirements. New products and markets for bonds are tailored to this contractor group, and federal, state and local governmental entities support enlightened programs in partnership with the surety industry. This combination has proved to be a powerful and effective way to make bonding available to the broad spectrum of contractors that need it.

A troublesome fallout of the economic downturn is the increasing undercapitalization of small contractors that, in turn, contributes to their bonding difficulties. Applications for lines of credit, the lifeblood of contractors, are being rejected at a record rate, and banks are lowering these lines for their existing customers, too.

In the absence of some form of expanded capital access, small businesses are having difficulty taking advantage of contracting opportunities in the economic stimulus package. And with reduced credit, some contractors are not able to obtain bonds in the amounts that they have in the past. This often is seen as a problem with the surety tightening its underwriting standards, but it actually is a problem of access to capital.

Model Contractor Development

During the past several years, The Surety & Fidelity Association of America's (SFAA) Model Contractor Development Program (MCDP) has been implemented successfully around the country, and current programs are under way in New York, Mississippi, Maryland, Texas, Illinois, Ohio and Washington, D.C.

The MCDP is a collaboration between the surety industry and local partners (usually state or local governmental entities) that consists of educational workshops that provide information on improving a construction company's operations. Bond readiness activities include one-on-one interactions with surety bond producers, underwriters and other professionals who work with the contractors on a case-by-case basis to assemble the materials necessary to complete a bond application and address any omissions or deficiencies that might deter the successful underwriting of a bond.

In its first year, the New York State Bonding Initiative resulted in more than \$30 million of direct bond placement, and the Mississippi program graduated more than 300 contractors in five locations throughout the state.

MCDP initiatives also include capital access components that address the working capital and collateral needs of contractors seeking bonding. Both the New York and Mississippi MCDPs employ capital access to support contractors participating in these programs. In New York, the capital access program provides working capital loans for contractors to support their cash flow needs once a contract has been awarded. Collateral lending also enhances their bondability.

In Mississippi, the capital access loan program increases the availability of financing for borrowers that might have difficulty obtaining conventional loans. Although these funds are not directly tied to bonding, access to such funds enhances a company's ability to obtain bonding by providing an incentive to the participating banks to provide a loan or line of credit to the contractor.

Pilot Programs

Drawing on these experiences, SFAA entered into a memorandum of agreement with the U.S. Department of Transportation (DOT) that includes a "pilot" capital access effort in which the DOT would fund the collateral often needed to meet bonding requirements. If successful, this regional pilot program will be implemented through state DOTs around the country.

SFAA also has a memorandum of understanding with Associated Builders and Contractors (ABC), and is exploring ways to incentivize small and emerging contractors to become ABC members by offering targeted access to the resources of SFAA's MCDP.

As small and emerging contractors struggle through what is likely to be a slow economic recovery, more will utilize these types of programs for collateral and their first bond, as well as to obtain working capital and bond increases. As a matter of policy, legislators at the state and federal levels should avoid the dubious fix of bond waivers and increased bonding thresholds, and instead fund and implement workable programs that address both access to capital and access to bonding for this critical sector of the contractor community.

Sam Carradine is director of development and diversity for The Surety & Fidelity Association of America, Washington, D.C. For more information, call (202) 463-0600 or email scarradine@surety.org.

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the contractor will default. If no bonds are in place and a default occurs, the state and local contracting entities bear the burden of re-letting work and paying any excess completion costs. Those costs ultimately are borne by taxpayers. Most state and local budgets currently have little or no leeway to absorb the extra completion costs from a contractor default.

Because waiving bond requirements permits contractors to bid on public projects without being required to provide payment and performance bonds, the result could be that financially unstable contractors—which otherwise cannot

obtain bonding and are not prequalified by sureties—would be bidding and obtaining public construction projects. This increases the risk of nonpayment for subcontractors and the risk of default to the state and its taxpayers.

BID PROTESTS LIKELY

In Oregon, state procurement officers have not used their temporary powers to waive bonds. But in Ohio, state and local procurement agencies face the difficult task of implementing their new law. Will state and local agencies have to let contracts for which some of the bidders have to provide

bid security and others do not? How many jobs can a small or emerging contractor bid on in order to get that first unbonded job? Who will keep track of how many times a small or emerging contractor bids to obtain a contract, and who will know if the contractor is on its first, second, third or 20th contract without bonds?

Contractors will be bidding without bonds to various state and local entities. What mechanism exists to detect and prevent a contractor from performing four unbonded jobs and then starting all over under a different company name or a change in ownership? If contractors are bidding on a job without bonds against other bonded contractors, which party will review the unbonded contractors to see if they can complete the job, and when in the process will this qualification be done?

Letting a job in Ohio in which the bids of small and emerging contractors do not have to include bid and final bonds, but the bids of other contractors must include bonding, could increase bid protests in the state. Under the Ohio procurement laws, the state must accept the “lowest responsible and responsive bidder.” For the state’s political subdivisions, it’s the “lowest and best” bidder. What if an unbonded small contractor is the low bidder? Do the public contracting entities in Ohio have enough authority under the statutory standards of “responsible and responsive” bidders and “best” bidders to award the contract to a bonded contractor? The new law may turn Ohio’s procurement process into a contentious and litigious mess.

There is good public policy for the universal requirement of surety bonds on public works projects. These bonds guarantee the project will be completed and that subcontractors, suppliers and laborers get paid. If a surety backs a contractor that defaults on the project, the full amount of the surety bond is available to complete the work and to pay the companies that performed work on the job.

It makes little sense in a weak economy to waive the protections of the performance and payment bonds required by state and federal law.

Lenore Marema is vice president of government affairs for The Surety & Fidelity Association of America. For more information, call (202) 778-3637 or email lmarema@surety.org.

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Congress Changes Rules For State Projects Funded By Stimulus Plan

BY ROBERT J. DUKE

A key underwriting consideration for a performance bond is a contractor's experience in performing work similar to the project being bonded. Included in this assessment is not only the nature of the work, but the type of owner. Experience shows that different owners, such as a private owner, a state agency or the federal government, present different rules under which a contractor must operate. Some of these rules may be informal, while others are formally written in the procurement code and regulations.

Experience with a particular type of owner indicates to the surety that the contractor has appropriate knowledge of the rules; moving from one type of owner to another usually means the contractor will face a learning curve.

However, what if the contractor sticks with the same type of owner, but the rules change? Such a scenario is under way with respect to state projects funded by the American Recovery and Reinvestment Act of 2009 (ARRA).

Not only do contractors entering an ARRA-funded state contract need to comply with applicable state statutes and regulations, but they also must comply with certain federal requirements.

WAGE REQUIREMENTS

Under section 1606 of Division A, Title XVI of the ARRA, all laborers employed by contractors and subcontractors funded in whole or in part by the ARRA must be paid wages at rates not less than those

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on similar projects in the locality as determined by the U.S. Department of Labor in accordance with the Davis-Bacon Act.

In other words, the law extends the prevailing wage requirements of the Davis-Bacon Act to state projects that use ARRA funds. With respect to work in states that do not have prevailing wage laws, adherence to Davis-Bacon Act requirements may affect the contractor's cost structure.

'BUY AMERICAN' REQUIREMENT

Under section 1605 of Division A, Title XVI of the ARRA, all iron, steel and manufactured goods used in the construction, alteration or maintenance of a public project funded in whole or in part by the ARRA must be produced in the United States unless the requirement is waived by the appropriate federal agency. Waivers must be based on a determination of non-availability, unreasonable cost or inconsistency with the "public interest."

To soften the requirement, section 1605 requires the application of "Buy American" requirements in a manner consistent with U.S. obligations under international agreements. Under some circumstances,

manufactured goods, iron and steel from a country other than the United States may be permissible if the state is a party to an international agreement (such as the World Trade Organization Government Procurement Agreement).

On April 3, 2009, the Office of Management and Budget released an interim final guidance that was meant to clarify the "Buy American" requirements in the context of financial assistance awards to states and other recipients. However, the guidance highlights only the intricate set of rules with which the state procurement agency and the contractor must comply.

INSPECTION OF RECORDS

Under section 902 of the ARRA, the federal Comptroller General is empowered to examine any records of a contractor or subcontractor on projects using ARRA funds. The Comptroller General also is empowered to interview any officer or employee of the contractor.

BONDING CONSIDERATIONS

As a result of the ARRA requirements, states are including special terms and conditions in contracts that are funded,

in whole or in part, with ARRA funds—creating new obligations for the contractors and subcontractors on the project. In light of these additional requirements, a surety's underwriting of a bond for a state project must take into consideration the new obligations.

Certain points of analysis include:

- Is the project funded wholly or partially by ARRA funds?
- Does the contractor have internal systems and processes in place to respond to federal oversight and audits?
- What are the particular "Buy American" requirements for the project? How will the contractor meet the requirements?
- Does the contractor's estimate account for any possible increased costs as a result of the requirements?

In light of the ARRA, a surety cannot be comforted solely by the fact that a contractor has extensive experience on projects in a particular state.

Robert J. Duke is director of underwriting and assistant counsel for The Surety & Fidelity Association of America. For more information, call (202) 463-0600 or email rduke@surety.org.



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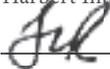
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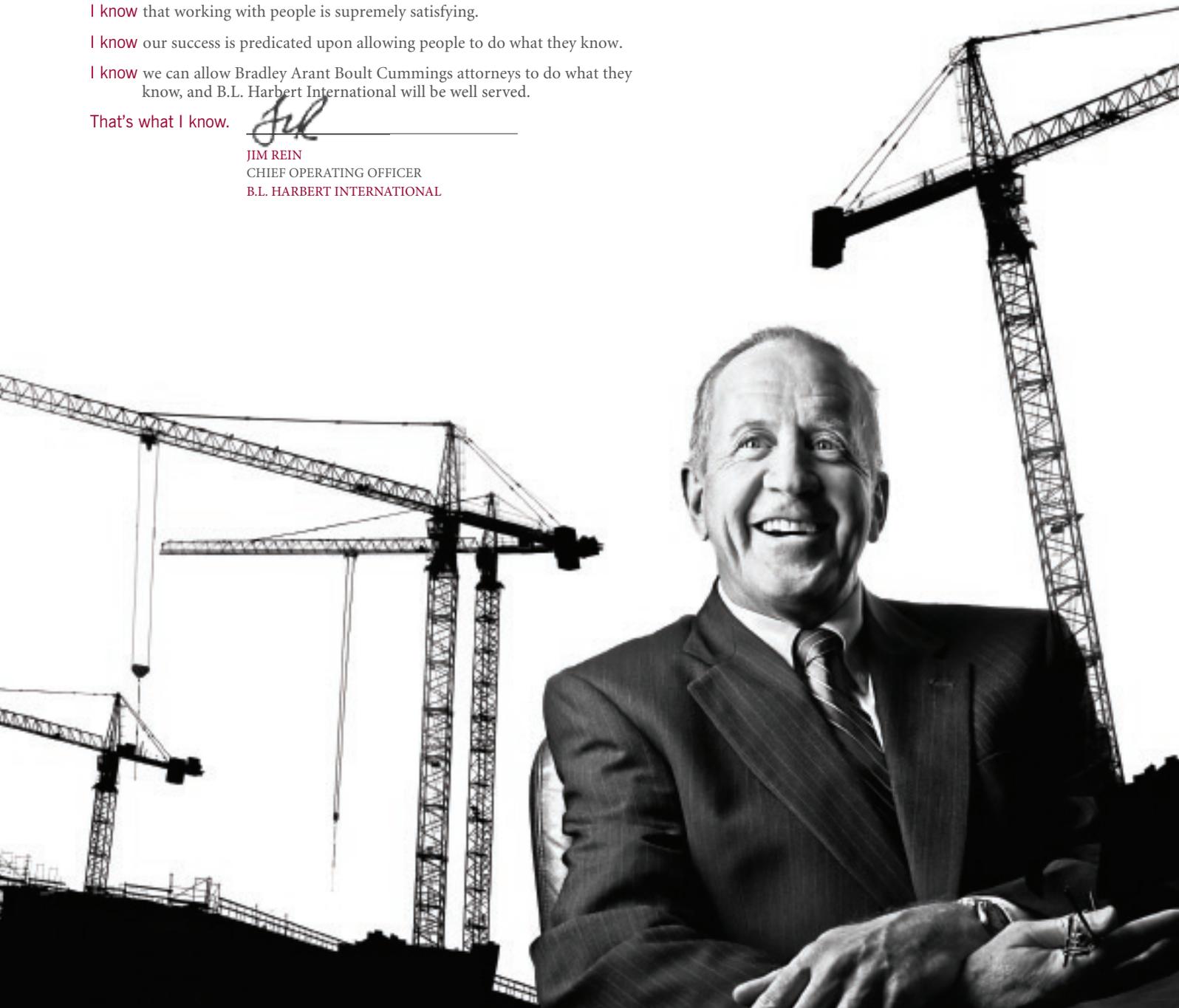
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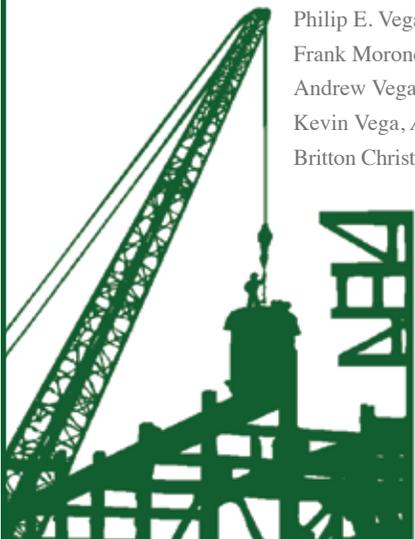
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