Surety Bond Producers and Underwriters

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BY MARC RAMSEY

WHILE SURETY BONDS are required on most public works construction projects, more bankers and construction lenders on privately owned projects are recognizing the value and benefits of specifying surety bonds as a condition of the construction loan.

Specifying a Bond

To specify a bond as a condition of a construction loan, the lender simply stipulates that a bond is required. In turn, the borrower includes the bonding requirement in the contract specifications. It is then the contractor's responsibility to contact a professional surety bond producer and obtain the necessary bonds.

With a surety bond in place, the lender's credit exposure is protected because the surety company has determined that, in its opinion, the contractor is capable of performing the project under the terms and conditions of the contract. If the contractor defaults, the lender is protected because the surety company fulfills the contractor's obligations, up to the limit of the bond.[1]

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The surety industry is an integral part of the construction business, and the surety team—the professional surety bond producer and underwriter—are a key asset of a contractor. For a clearer picture of how surety bonds benefit bankers and construction lenders, it is helpful to take a closer look at the roles the producer and the underwriter play in the bonding process.

Surety Bond Producer

Once the bond requirement has been stipulated in the contract specifications, it is the contractor's responsibility to obtain the bond. Most surety companies are subsidiaries or divisions of larger property and casualty insurance companies. Since most surety companies distribute surety bonds through agents, the contractor's first step is to contact a professional insurance agent or broker who specializes in contract surety and knows how to apply for and obtain surety bonds. This agent is sometimes referred to as a *bond producer*.

The producer is an integral part of the contractor's external advisory group, which includes attorneys, lenders, and auditors. The producer is expected to be familiar with local, regional, and national trends and conditions in surety markets. Other attributes include:

- Knowledge of construction accounting and finance.
- Respect in the construction industry and a reputation for integrity.
- Knowledge of contract documents and contract law.
- Experience in strategic planning and management practices.

The producer conducts an initial review of the contractor's business and operations and gathers financial documents for submission to the surety company. In some

Play Key Role *in Construction*

cases, the producer may analyze the financial statements to determine the contractor's working capital, net worth, and current revenue.

The producer's specialized knowledge of the construction industry enables him or her to match the contractor's needs and strengths with the surety company that will best support the contractor. (Most surety bond producers maintain a business relationship with several surety companies because sureties vary in their market focus and risk appetite.) The producer will help prepare the contractor for the surety company's rigorous prequalification process. After meeting with the contractor and gaining an understanding of the firm's business and needs, the producer tailors the contractor's submission to the surety's specific requirements and guides the contractor through a formal presentation.

The producer recommends a responsible surety line of credit consistent with the contractor's capabilities, provides the surety periodic updates concerning the contractor's operations, and reviews contract documents to provide guidance on the project's potential risk. The producer helps the contractor establish and foster a business relationship with the surety company and maintains communication between the two with periodic reports on work

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What the Surety Team Expects from a Contractor's Business Plan

The strategic business plan is a contractor's road map for managing growth and risks. The surety bond producer and underwriter are partners who help the contractor follow the plan.

By Marc Ramsey

Although the surety team places a lot of focus on the contractor's finances and financial structure, they also are interested in other elements of the contractor's business. Surety bond producers and underwriters want to know how the construction business is being run. The contractor's business plan for the next 12 to 24 months offers extremely important insight into the contractor's operations. It illustrates not only where the construction company is headed in the future, but also how the company plans to get there.

For example, if a contractor with a $50 million aggregate surety program states in his or her business plan that the company plans to grow 10% a year, the surety will expect the contractor to need an additional $5 million in surety credit the following year for a program total of $55 million. If the contractor instead requests a $75 million surety program, then that indicates a definite disconnect between how much surety credit the contractor actually needs and can support and how much he or she is seeking. The contractor may be overly ambitious about what he or she thinks the company can accomplish and may not be considering the financial support and other resources necessary to attain its objectives.

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It's not enough to have a business plan. Today's contractors need to demonstrate their ability to adhere to the plan or justify why their company wishes to stray from it. The strategic business plan is a construction company's road map for managing its growth and risks. The surety bond producer and underwriter are strategic partners who help the contractor follow the plan.

The Importance of Understanding the Risks

Contractors need to understand risks and make sound judgments in order to evaluate and manage their risks, both external (owners, weather, and materials prices) and internal (capital fluctuations, equipment, and staff).

Taking any and every job available is not a wise strategy. A good construction company positions itself to pick and choose the projects it pursues. The best contractors understand their organizations, capabilities, and experience and are able to use this knowledge to maximize their economic returns. Consequently, surety companies look for contractors that are well managed and have consistent positive earnings histories, good accounting and estimating systems, and proper controls and procedures in place to catch problems early. The surety wants to see that the construction company has a thought-out game plan for where it is going and is not a company that engages in ad hoc decision making.

A well-managed contractor will take advantage of an opportunity when it is available, but also be aware of the limits of its resources. A construction company with an established surety relationship built on trust and communication, and a proven record of doing what it says it will do, can be confident that the surety will be ready and available to provide additional surety credit where it makes sense. However, a contractor should not expand its operations beyond its capacity or become out of alignment with its plan.

Sureties prefer to see incremental growth, consistent results, and a strong financial condition. The construction company should demonstrate its commitment to grow its revenue commensurate with its financial base. Sureties are more cautious about contractors that heavily leverage their equity to support rapid growth.

For sureties, it's not just about looking at financial statements and work-in-progress statements. They seek a real understanding of how a contractor will drive the business in the short and long terms. A properly constructed strategic business plan fills in the blanks with a vivid, 360-degree picture of a contractor's organization, giving the surety the lenses needed to read between the lines of a financial statement, see the complete picture, and partner in the contactor's success. ❖

progress, financial performance, and business plans. Additional responsibilities include providing sound business advice and technical expertise, as well as introducing the contractor to professionals or consultants if needed.

Surety Underwriter

After collecting all of the necessary information, the producer submits it to a surety company underwriter, who works directly for the surety company providing the bond and undertaking the obligation.[2]

The underwriter takes an in-depth look at the contractor's entire business operations and evaluates whether the contractor has the experience to complete the contract successfully and has (or can obtain) the necessary equipment needed to perform the work. The underwriter also must determine if the contractor has 1) the financial strength to support the contract work program, 2) a positive track record of paying subcontractors and suppliers promptly, and 3) an established line of credit with its bank. Sureties generally look for a line of credit that can be used to meet short-term cash requirements.

The underwriter looks at the contractor's fiscal year-end statements for the past three to five years, including:

- Accountant's opinion page and the scope of the CPA's review (audit, review, or compilation).
- Balance sheet to assess the working capital and overall financial condition of the construction company.
- Income statement to review gross profit on contracts, operating profit, and net profit before and after taxes.
- Statement of cash flow to assess operating cash flow, capital expenditure requirements disclosed in the cash flows from investments, and the degree of external debt and equity changes in the financing cash flows.
- Accounts receivable and payable schedules to measure collection speed, trade debt exposure, customer concentration, and vendor concentration.
- Schedules of work in progress and contracts completed to evaluate the financial performance of each contract and provide insight into the potential for future earnings from contracts in progress.
- A schedule of general and administrative expenses to see how well overhead expenses are controlled and managed.
- Any explanatory notes that the contractor's accountant may have included with the financial statements.
- A management letter, if available, to review the CPA's findings, observations, and recommendations about the contractor's accounting processes.

Other fundamentals the underwriter considers include:

- An organization chart that shows key employees and their responsibilities.
- Detailed resumes of key employees.
- A business plan outlining the type of work the

What Is Surety Bonding?

Surety bonding is a three-party agreement among the construction project owner, the contractor, and the surety company. Each party has specific responsibilities and obligations to the other. Surety bonding shares some characteristics of bank credit in that the surety company and its financial resources stand behind the contractor so that the contractor is able to enter into a contract with an owner. The owner receives a bond from a financially responsible surety company licensed to transact suretyship, and the bank receives assurance that the project it finances will be completed.

Surety bonding is a three-party agreement among the construction project owner, the contractor, and the surety company.

When a lender is added to the bond, the bond becomes a four-party obligation. The new lender is added to the bond through a dual-obligee rider, which names the lender as an additional obligee, or beneficiary to the bond, which enables that lender to invoke the benefits of the bond. Under the terms of the rider, the rights of the additional obligee (lender) are dependent on and subject to the fulfillment by the original obligee of its obligations under the contract.

If the owner breaches the construction contract, this act affects not only the rights of the owner but also the rights of the lender.

Under a bond with a dual obligee, two different parties are beneficiaries of the bond, but the limit of the bond is not increased. A dual-obligee rider can give the surety the right to issue a joint check to the owner and the lender if a dispute between them should arise. The purpose of a dual obligee is to allow a lender to become an additional beneficiary to a bond without altering the bond itself or expanding the surety's obligations. ❖

construction company does, how it obtains its jobs, the geographic area where it operates, and growth and profit objectives.
- A description of work in progress, both bonded and nonbonded. The underwriter also will look at past projects and any plans for future work.
- A plan outlining how the business will continue in the event of the owner's or a key employee's death or disablement.
- References from subcontractors and suppliers.
- Letters of recommendation from project owners, architects, and engineers.

All parties in the construction process, especially the lender, want timely project performance and completion. Unlike other risk mitigation methods, surety bonds are designed to prevent contractor default through stringent prequalification in which bonds are provided only to contractors that the surety believes can perform the obligation. Surety bonds also provide the assurance of project completion if the construction company is unable to fulfill its contractual obligations. Therefore, the surety team puts the contractor through an extensive vetting process to ascertain the firm's capabilities.

Essentially, a payment and performance surety bond means qualified contractors and competitive bids. A surety bond should not reduce a contractor's borrowing capacity, and, in fact, it should be viewed as a credit enhancement. Subcontractors and suppliers may give better prices and credit terms when they know they are protected by a payment bond, and the payment bond protection also reduces the risk of liens. The surety bond producer works with the surety company's underwriter to ensure that the contractor is bondable and capable of performing the work and paying all parties. ❖

Surety bonds also provide the assurance of project completion if the construction company is unable to fulfill its contractual obligations.

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Notes

1. Usually, the performance bond and payment bond are each in the amount of 100% of the original contract price, and the limits are not reduced as the project progresses. Therefore, the limits available to cover the work to be completed generally are more than sufficient.

2. Underwriters may request a meeting with the contractor, who should be prepared to discuss all aspects of the construction company's current operations and future plans.