

Opinions expressed are those of the advertisers.



Insurance Today II

# The Surety Industry

Rebuilding America: Preparing for Increased Infrastructure Spending

## WHAT'S INSIDE

- ◆ Market Overview
- ◆ Executive Viewpoints
- ◆ Avoiding Pitfalls
- ◆ Mitigating Risks
- ◆ Sustainable Planning

MARCH 11TH, 8:01 A.M.

# A CONTRACT WON AND A RELATIONSHIP REAFFIRMED

**IN AN  
INSTANT,**  
ERIC LOFTON  
SAW THE VALUE  
OF CNA SURETY

It would be their largest contract undertaken — installing the HVAC system for the nation's largest new shopping mall. Needing to provide a Performance and Payment Bond, Eric Lofton worked closely with his independent insurance agent and the experienced underwriters from CNA Surety. Eric's agent arranged a site visit with the mall developer, and helped Eric secure the bond that ultimately sealed the deal. Way to build your business, Eric.

To learn more about the complete range of CNA Surety bonds for construction, contact your local independent insurance agent, or visit [www.cnasurety.com](http://www.cnasurety.com).

Construction • Education • Financial Institutions • Healthcare • Manufacturing  
Professional Services • Real Estate • Retail • Technology • Wholesale Distribution

**CNA**

We can show you more.®

The examples provided in this material are for illustrative purposes only and any similarity to actual individuals, entities, places or situations is unintentional and purely coincidental. Please remember that only the relevant insurance policy can provide the actual terms, coverages, amounts, conditions and exclusions for an insured. All products and services may not be available in all states and may be subject to change without notice. "CNA" is a service mark registered by CNA Financial Corporation with the United States Patent and Trademark Office. Certain CNA Financial Corporation subsidiaries use the "CNA" service mark in connection with insurance underwriting and claims activities. Copyright © 2017 CNA. All rights reserved.



A black and white photograph of a middle-aged man wearing a white hard hat, a dark suit jacket, a light-colored dress shirt, and a dark tie. He is holding a rolled-up set of blueprints in his left hand and looking directly at the camera with a serious expression. The background is dark and out of focus.

# tell your contractor you have a surety solution

WE ARE ACSTAR. We excel at contractor surety cases the “standard market” would rather avoid. Because we know these kinds of cases inside and out, we can offer the *best terms available* and provide the *quickest turnaround*. So when “standard” solutions won’t work, talk to us first. Then tell your contractor, *problem solved*.

Call ACSTAR at (860) 415 8400.

Surety Bonding • Treasury Listed • Rated **A** by A.M. Best • Licensed Nationwide • 30 South Road, Farmington, CT 06032  
Henry Nozko Jr., nozkojr@acstarins.com • Henry Nozko III, nozko3@acstarins.com • acstarins.com



SURETY FOR AN IMPERFECT WORLD



# Surety Market Overview

By Bryan Surcouf, Communications Manager, The Surety & Fidelity Association of America

**There are nearly 4 million miles of roads**, 600,000 bridges, 90,000 dams, 140,000 miles of track with more than 100,000 rail bridges, 3,000 airports and close to 100,000 public schools throughout the United States. The American Society of Civil Engineers rates the overall infrastructure in the United States as a “D+.” Needless to say, America’s infrastructure is in desperate need of updating. Politics aside, the proposed \$1-trillion infrastructure budget by

the current administration signals increased opportunities for the nation’s construction industry.

The Surety Information Office (SIO) explores Rebuilding America: Preparing for Increased Infrastructure Spending. Through a combination of interviews and discussions with industry leaders, along with examining market trends, the SIO offers practical insights to help prepare the construction industry for the increased infrastructure spending.

The U.S. Census Bureau reports a 4.2% growth rate for the entire construction industry in 2016, while The Surety & Fidelity Association of America (SFAA) reports a 7% growth in the surety market from 2015 to 2016. The continued growth levels indicate a greater market capacity for underwriting surety bonds. Ross Fisher, chair of SFAA and senior vice president of Specialty Commercial for The Hartford, says, “With surety growth ambitions and so much surety capacity available, credit-worthy—and even some less than credit-worthy—companies can find surety capacity on acceptable terms.” An increase in capacity coupled with a range of products, such as bid, performance and payment bonds, means that surety bonds have never been a smarter investment for companies seeking to benefit from a potential infrastructure bill.

## Small

The surety market for the small contractors remains highly competitive—in line with the previous year. The SBA Surety Bond Guarantee Program continues to offer small contractors the opportunity to bid on larger contracts. The program guarantees up to \$6.5 million, while fast-track bond programs for construction companies with positive credit scores keep the market robust.

“During my 44-year career in the surety industry, I have never witnessed such an aggressive market for small contractors,” says Howard Cowan, president of NASBP. Michael Gross, vice president of contract surety for CNA Surety, adds, “A record number of new surety firms have entered the market in the past 10 years, with many having an appetite for small contractors that have a solid business plan emphasizing controlled growth.”



## Medium

Similar to the small market, the medium market remains extremely competitive, particularly for the more established companies with solid balance sheets. “This is the ‘sweet spot’ for virtually every surety,” Cowan explains. “Companies are competing to keep their existing accounts and to add to their book of middle-sized contractors.”

One issue with this market is that contractors may attempt to grow beyond their capacity. According to Josh Penwell, vice president of contract underwriting for Merchant’s Bonding Co., “A larger number of surety markets are marketing for small- and medium-size accounts. Underwriters are challenged to remain disciplined, as contractors in the middle market may have interest in expanding outside of their normal geographical area or pursue projects that are much larger or more complex than their typical projects.”

## Large

As a record number of surety firms entered the market over the past 10 years, the large surety market remains extremely competitive. “Large contractors that have maintained adequate balance sheets have ample surety capacity,” Penwell says. “There are certain sectors, such as oil and gas and health care, where the amount of work is increasing, and larger contractors are taking advantage of that.”

The opportunities for growth and available bonding capacity at this level are not without risk. “Surety companies actively embrace large contractors, but underwriters understand that this market has the potential to be challenging due to many contractors attempting to ‘take the next step.’ Underwriting centers on managing risk and growth, cash flow and earnings retention,” Gross says. “Underwriters are being challenged to properly analyze the risk associated with creative delivery systems, such as public-private partnerships,” Penwell adds.

## Mega

Only six surety companies work with the mega contractor market. These projects are more complicated and require underwriters to fully understand not only the contractual and operational risks involved but also the individual contract provisions, such as shortened schedules. Those sureties and contractors with the capital can make a lasting impact in this market as the backlog of contracts approaches the billion-dollar range. “More states have passed or will pass legislation

---

**The U.S. Census Bureau reports a 4.2% growth rate for the entire construction industry in 2016, while the SFAA reports a 7% growth in the surety market from 2015 to 2016.**

---

enabling the P3 delivery method, and the federal government is expected to ramp up the number of P3 projects,” Gross says. “Infrastructure spending will most certainly increase. Finding qualified labor for the expected increase in projects is paramount to success.”

## Contractor Failure

Construction is a risky business. Unforeseen issues can cause even well-established contractors to default on a project. There are many reasons for contractor failure, but two of the most recognized are when contractors attempt to venture out of their area of expertise or geographic area without fully understanding the new market. Onerous contract terms also can play a role in default for contractors.

Markel Surety President and COO Michael Keimig says, “Contractor failures increased slightly in 2016—but not at an alarming rate. Larger than the impact of more frequency is the impact

of rising costs to complete bonded projects in default due to material and labor price escalations. On the prime level, margins are holding steady to inching up slightly depending on the region. Subcontractors are more able to put margin in their bids, but the increased pressure to find skilled labor adds inherent risk to their work.”

“Contractors’ profit margins appear to be improving,” Cowan adds. “The major contractor failures that did occur have caused significant losses to the writing surety. In the small and middle markets, claims activity, but not necessarily losses, has increased. Payment bond claims appear to be more common than performance bond issues.”

## Value and Protection

Surety bonds are the best protection for consumers, businesses and taxpayers. “We are in the era of potential alternative options to contractor surety bonds, including subcontractor default insurance, corporate guarantees and ILOCs,” Gross says. “None of the alternatives can bring the total package that a surety bond brings, including 1) payment to all subcontractors, laborers and suppliers; 2) the most rigorous and educated prequalification process; 3) administration of completion of the contract; and 4) price that is generally less expensive than alternatives.”

“An often unseen and underappreciated benefit of a surety bond is the prequalification process provided by the surety,” Cowan says. “It adds the considered judgment of a major financial corporation that the contractor will successfully perform the contract and pay the associated bills. If its judgment proves to be faulty or unforeseen events create a default, the surety’s financial assets will pay for the additional costs up to the penalty of the bond.”

“Capital is at a premium, and surety bonds protect an owner or general contractor’s capital from the unexpected,” Keimig adds. “You cannot predict pressures that impact a construction firm over the life of a project, but for typically less than 1%



## Not all projects are this simple. That's why you need Travelers' new EDR bond.

When a dispute disrupts your project, getting it resolved quickly can save the schedule, the budget and your reputation. Travelers' new Expedited Dispute Resolution (EDR) bond provides a speedier path to resolution.

Travelers' EDR bond offers a 100% performance guarantee and a streamlined claim process. You'll work with a dedicated claims professional to resolve disputes within 45 days. With the EDR bond, you can be confident that disputes, no matter how complex, will reach resolution quickly so that your projects stay on track. Talk to your Travelers agent today.



[travelers.com](http://travelers.com)

© 2017 The Travelers Indemnity Company. All rights reserved. Travelers and the Travelers Umbrella logo are registered trademarks of The Travelers Indemnity Company in the U.S. and other countries. CP-8953 New 4-17

of the contract price, you can protect your investment. In a typical default scenario, that 1% premium protects against what could equate to a full contract price loss. As a private owner or prime contractor, one of your greatest risks in delivering a project is the loss of capital due to faulty workmanship or unpaid subs or suppliers. A surety bond equates to capital preservation with both a prequalification component and a dispute-resolution provision.”

Merchant’s Penwell believes the three main reasons a construction owner or contractor should require performance and payment bonds are:

- Surety underwriters are trained to evaluate the risks associated with various contractors and also determine the appropriate levels of projects and programs that a contractor should undertake. The premium charged for this service is more cost effective and efficient than attempting to handle this internally.
- The payment bond provides protection against subcontractors and suppliers who could lien the project if they don’t get paid. The payment bond mitigates the exposure from second-tier subcontractors, suppliers to subcontractors and union dues.
- Performance and payment bonding will help ensure that project owners, architects, lenders and end users will be satisfied. It will save substantial overhead expenses in the form of lower legal fees, less management time spent on nonproductive issues and less time spent sending unnecessary correspondence.

### Private Construction and Surety Bonds

As private owners and banks attempt to mitigate the risks associated with construction, there has been a growing trend to require surety bonds. Bank lenders are leading the way in the private construction arena. “There does seem to be a growing trend by private owners (or banks) to require bonds for

their projects—and that’s just good business,” Keimig says. “We are seeing an increase in the use of payment and performance bonds from both general contractors and in the private sector,” Penwell adds. “Sophisticated general contractors and risk-averse private owners understand that payment and performance bonds are a cost effective and efficient way to mitigate the risk of contractor and subcontractor failure.”

Gross expanded on the subcontractor bond market by adding, “Subcontractor bonding has been on the decline over the past five years due to the increased

---

*“Capital is at a premium, and surety bonds protect an owner or general contractor’s capital from the unexpected. You cannot predict pressures that impact a construction firm over the life of a project, but for typically less than 1% of the contract price, you can protect your investment.”*

---

—Michael Keimig, President and COO, Markel Surety

use of subcontractor default insurance (SDI) by large general contractors. However, due to experience with SDI over the past few years, surety companies are writing more subcontract bonds for general contractors that use SDI but are excluding specific subcontractors due to increased perceived risk. Outside of SDI, the use of subcontractor bonding has been consistent with prior years. The biggest change is that contractors are becoming more sophisticated in prequalification,

and most continue to use subcontractor bonding in one form or another as part of that prequalification process.”

### Looking Ahead

Leaders and industry experts predict that the surety market will remain strong, and they expect to see a continued increase in contractor revenues and margins throughout the remainder of 2017. The potential \$1 trillion in additional infrastructure spending over the next 10 years will help this trend to continue.

When looking to the future, Fisher states, “The surety marketplace is strong based on the improving construction economy and the fact that construction companies have weathered the 2009–2012 downturn pretty well. When our customers are doing well, the surety marketplace generally reflects that. The product line is profitable, contractors and other users of surety have many choices, and most will find plenty of capacity.”

“Forecasted moderate growth in construction spending will keep work plentiful,” Keimig adds. “The greatest risks to the industry will be continued upward pressure on interest rates and materials pricing, and the impact of a dearth of skilled labor, which will cause projects to take longer and cost more. As well, these same pressures will drive up the cost to complete defaulted work.”

Penwell concludes by saying, “Without disciplined underwriting, contractors that have backlogs of work that are larger, have thin margins or have work in areas where they lack experience will have challenges. The availability of skilled laborers is a big concern as talk of infrastructure money becomes reality. It could be a factor in increasing losses if contractors don’t properly manage their personnel. We expect to continue seeing unfavorable terms and conditions that will challenge contractors. Surety capacity is plentiful, with stable underwriting results, a number of new markets entering the surety industry, and several reinsurance companies attempting to expand by establishing primary operations.” ♦



# surety.

A \$9.7 billion Treasury listing.\*  
Ready, willing, and committed to  
custom-crafting your surety.

\*Surety is underwritten on the paper of National Indemnity Company,  
which has a U.S. Treasury listing of \$9.7 billion.



Berkshire Hathaway  
Specialty Insurance®

## strength.

A STRONG TEAM  
OPERATIONALIZING  
A STRONG BALANCE SHEET.



HIIG | CONSTRUCTION

**All successful contractors include insurance in their plans**



**Comprehensive and competitive  
Risk Management Programs including:**  
**Commercial General Liability**  
**Commercial Automobile**  
**Workers' Compensation & Employers Liability**  
**Property and Inland Marine**  
**Excess Liability**

Ask your Broker to send your  
applications to:

Construction@HIIG.com

Contact: Jon Oppenheim,  
President HIIG Construction  
(770) 701-2586



**HOUSTON INTERNATIONAL INSURANCE GROUP**

Wholly owned HIIG Insurance Companies are rated A- and better by A.M. Best

# Executive Viewpoints

## What do you believe the new federal administration's anticipated infrastructure plan will mean for the surety market?



**Michael Gross,**  
**Vice President of**  
**Contract Surety,**  
**CNA Surety:** The  
forecasted expansion

will result in new work and profit opportunities, and the surety industry is ready to help its qualified contractors responsibly grow. There is sufficient capacity in the surety market to bond the anticipated increase in spending. The nature of the expansion will require sophisticated surety support with the capacity to support larger projects at varying delivery methods, especially the intricacies and contractual complexity of the anticipated increase in P3 work.

Writing more bonds carries additional risk, as higher surety premium does not always translate into more profit. Overextension is one of the leading causes of contractor failure, and a large infrastructure plan may stretch contractors both operationally and financially. Contractors that have a deep workforce, including access to sufficient labor, will have an advantage. Capital requirements will be discussed by surety companies to ensure their clients will have the financial means to cash flow the expansion and weather potential storms.

Strong strategic leadership will be the key to success not only for contractors but for their surety partners as well. The expansion provides an excellent opportunity for both the surety and contractor to strengthen their relationship by increasing communication.

## Is the U.S. construction industry ready to address a trillion dollars in infrastructure spending?



**Michael Keimig,**  
**President and COO,**  
**Markel Surety:**

While the industry has made great strides in recent years with more efficient delivery models and construction methods, the impact of a trillion dollars of construction spending would be major. At current spending levels, there is already a significant amount of pressure on the skilled labor market. Adding that level of work on top of it would perhaps be more than

creates risk, well-managed risk is the engine for profit, and profit comes from risk that you can see, price and manage.

For general contractors, surety bonds fit within an overall risk management program. Bonds can provide real protection when used alongside a thorough sub prequalification process, proactive project management and cost accounting, and the use of various risk transfer tools. Used in this way, surety bonds can protect against subcontractor risk, allowing a general contractor to stretch into larger projects, larger

*“Growth creates risk, well-managed risk is the engine for profit, and profit comes from risk that you can see, price and manage.”*

—Ross Fisher, Senior Vice President, Specialty Commercial, The Hartford, and Chair, SFAA

the industry could bear. While the contractors that have the best training and labor sourcing practices may fare better than the others, the entire industry would be impacted by the trickle-down effect. Along with the skilled labor shortage, the working capital needed to fund the increased backlogs would put major cash-flow hardships on many firms. These issues would almost certainly lead to more contractor failures and highlight even further the benefit of surety bonds.

## How can surety bonds help contractors grow and be profitable?



**Ross Fisher,**  
**Senior Vice**  
**President, Specialty**  
**Commercial, The**  
**Hartford, and**  
**Chair, The Surety**  
**& Fidelity Association of America:**  
Growth and profit sound great, but neither exists without risk. Growth

backlogs, and other new opportunities as part of a business plan to grow and improve the company's profitability.

For subcontractors, surety bonds are an affirmative statement of one's qualification to do the work and pay bills. While this may not help manage the subcontractor's risk, it does make subcontractors more attractive to general contractors and, in some cases, project owners who are trying to manage their risk. Used proactively and confidently, surety bonds can help subcontractors win work on more attractive terms because the sub represents reduced risk for the potential client, the general contractor or project owner.

Confidence is key for general contractors and subcontractors—confidence that the bonding company knows them, their organization and long-term plans, and is willing and able to support them when proactively choosing to use surety bonds. Neither GCs nor subs can run a business looking over their shoulders to see if their surety company is still with them.



**Howard Cowan,**  
**President, NASBP,**  
**and Principal,**  
**Cowan-Hill Bond**  
**Agency: Surety**  
bonds are a critical

resource for contractors wishing to grow and become more profitable. The key ingredient provided by the surety industry is the guidance provided by surety underwriters and producers in their roles as trusted professional advisors. Whether it is a new construction company or one that has experienced financial and/or operational difficulties, contractors are likely to spend more time with their surety advisors than their CPAs, lawyers or bankers. The reason is not that the underwriter or producer has more expertise in those areas; it is because they are in the best position to maximize and coordinate the talents of the contractors' professional advisors. The surety bonds that result from such coordination put the contractor on a path to both profits and growth. The frequent contact with the contractor and the continuous prequalification done by the surety industry not only leads to growth and profitability, but it also helps the contractor become a better business professional.

### What steps can contractors take in preparation for more infrastructure spending?



**Gregg Lyon, Second**  
**Vice President and**  
**Strategic Officer,**  
**Construction**  
**Surety, Bond &**  
**Specialty Insurance,**  
**Travelers:** Given the current state of

Infrastructure in the United States, it is clear that the country needs to address the aging infrastructure problem. Politically, the House and Senate concur that an increase in federal infrastructure spending is warranted but disagree how to pay for the increased spending levels. To put it in prospective, the President has discussed a \$1-trillion infrastructure package over 10 years, and the Senate

Democrats have floated the idea of a similar-size package. The questions at this point are:

- How long will it take for Congress to pass a new infrastructure spending bill?
- What will the new infrastructure spending bill look like?
- What is the time frame before shovels are in the ground?

Since financing is one of the main obstacles to reaching a compromise for a new infrastructure bill, a possible solution could involve the expanded use of public-private partnerships. P3 spending has increased in the United States, and a number of states recently passed P3-enabling legislation. We also understand that several large private equity firms in the United States are working on new funds to finance infrastructure spending.

either in the short term or long term, there are a few critical areas we suggest to focus on:

**Staffing:** Review your staffing plans to confirm your company has the expertise to grow and expand. Recognizing the relatively tight labor markets, getting out ahead of resource needs can be one of the biggest success factors for your company, as it gives you a head start on identifying the right talent now.

**Systems:** Review internal systems and confirm they are meeting expectations and can support your growth plans. We recently conducted a review of accounts that encountered financial difficulties, and one common deficiency we noted was in the area of internal cost systems—more specifically, the lack of good internal financial controls. It's not about having

*“Recognizing the relatively tight labor markets, getting out ahead of resource needs can be one of the biggest success factors for your company.”*

—Gregg Lyon, Second Vice President and Strategic Officer,  
Construction Surety, Bond & Specialty Insurance, Travelers

As a contractor prepares its organization for future infrastructure opportunities, or any growth opportunities for that matter, there are a number of steps we believe our clients should take to best position themselves for future success:

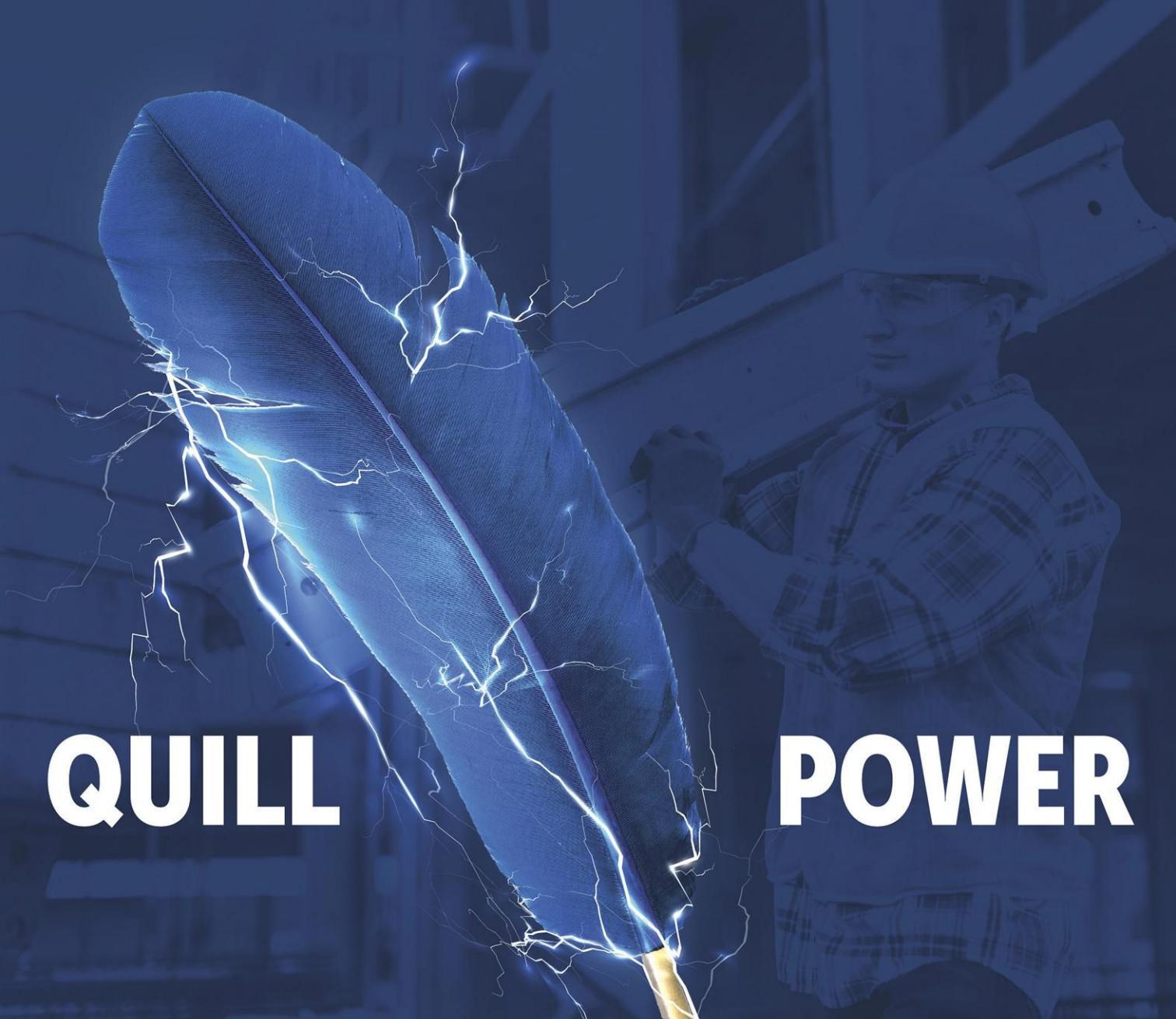
1. Ensure that your strategic business plan is up to date and action plans are clearly identified.
2. Share this plan across your organization so that the stakeholders at all levels of your company take ownership and have accountability.
3. Also share your strategic business plan with your key business partners, including your surety, surety agent and bank.

If your business plan is to grow,

a good system in place, it's about using that system effectively to manage your business.

**Financial:** Ensure that your balance sheet can support the future opportunities you are looking to pursue. An emphasis should be put on liquidity, capital and bank support to handle an influx of new projects or growth in general. The last thing you want to do is to have ample work opportunities without the financial wherewithal to execute on them.

While the White House and Congress debate various proposals, this pause gives infrastructure contractors adequate time to review their individual operations and capabilities to make sure they are ready for the long overdue increase in infrastructure spending. ♦



# QUILL

# POWER

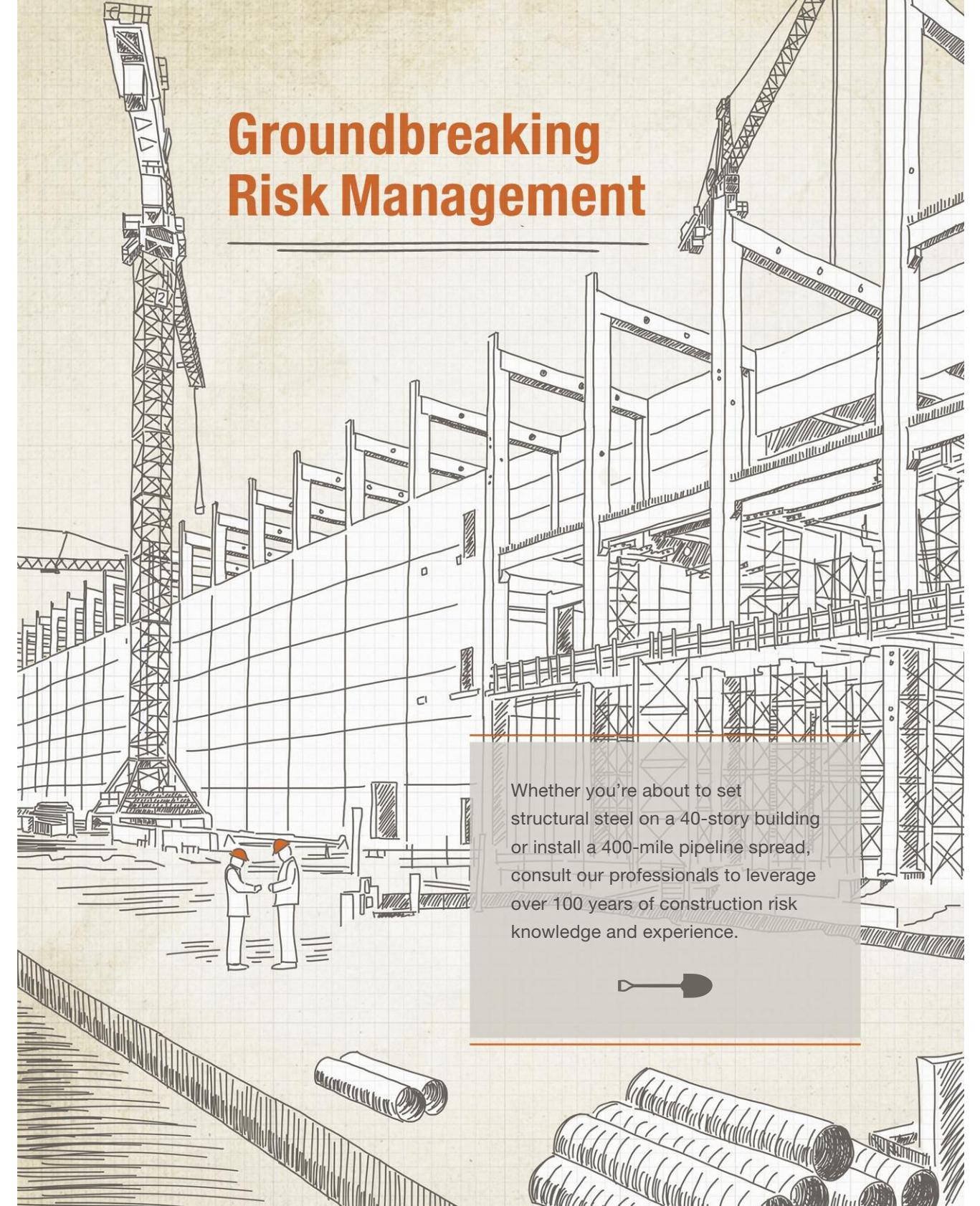
Ask your surety agent about the **common sense** power of Merchants' quill.

  
**MERCHANTS**  
BONDING COMPANY™  
COMMON SENSE SURETY SINCE 1933



1.800.678.8171 | [www.merchantsbonding.com](http://www.merchantsbonding.com)

Merchants Bonding Company™ (Mutual), Merchants National Bonding, Inc. & affiliated companies | 6700 Westown Parkway, West Des Moines, IA 50266



# Groundbreaking Risk Management

Whether you're about to set structural steel on a 40-story building or install a 400-mile pipeline spread, consult our professionals to leverage over 100 years of construction risk knowledge and experience.



**McGRIFF, SEIBELS & WILLIAMS, INC.**  
CONSTRUCTION RISK SERVICES

[McGriff.com/construction](http://McGriff.com/construction)



## Infrastructure Repair and New Building: Avoiding Pitfalls in an Expanding Market

By Michael Gross, Vice President of Contract Surety, CNA Surety

**We are on the brink of a potentially significant and rapid expansion** in infrastructure spending. An increase in the number and size of construction projects is always a welcomed occurrence, as more work should translate into shorter bidder lists, higher margins on bid day and, most importantly, more winning bids. But why is the contractor failure rate relatively the same during an expanding market versus a recessionary market? Why do many contractors take on more risk but make less money at higher sales volumes? The answers center around three main pitfalls to avoid in expansion: loss of controls, insufficient risk mitigation and inadequate attention to capital requirements.

When backlogs increase, in an effort to meet deadlines and mitigate potential problems, previously implemented organizational and financial controls are often put on the back burner. Organizational control discipline may be softened in areas such as failure to implement a business plan, centralized checks and balances in bid review, weekly meetings to discuss projects and lessons learned, and overall failure to quickly place significant additional resources on problem jobs. Lax internal controls during increased backlog levels most often result in late diagnostics of problem projects, causing costs to rapidly escalate, sometimes to runaway status. Proper financial controls are equally important during expansion. Set and maintain detailed metrics, and incorporate those metrics in the business plan. Most surety companies will provide benchmark reports to be used as a financial comparison tool, and that can be incorporated into financial metrics and goals.

Contractors are being asked to take on more risk than ever before, and there are more constraints in place that can

derail profitability plans, even in an expanding market. Risk management techniques are more important than ever. Examples include negotiating out unfair, onerous contract provisions, rigorous and disciplined subcontractor prequalification, properly anticipating and addressing potential labor shortages, confirmation of financing, avoiding the temptation to aggressively pursue work out of territory and scope, and working with outside professionals who are aligned with your goals and understand your need to grow. Joint ventures are often overlooked but should be seriously considered, with the right partner,

**Follow the adage of never taking on a project that by itself could put your firm out of business.**

to spread risk and maximize surety capacity. Early establishment of detailed continuity plans, both organizationally and financially, help the organization in many facets, including leadership transition, key employee progression and retention, and overall capital preservation.

Follow the adage of never taking on a project that by itself could put your firm out of business. This may seem elementary, but on occasion, contractors sign contracts that contain unlimited actual and consequential damages or take on projects that are significantly above the firm's capability. Measured growth and measured risk taking are important considerations during expansion.

Having an experienced CFO with commensurate experience to the size and sales of your firm will help navigate the additional capital constraints placed on your business.

Most companies forecast sales and profit, but cash flow forecasting, both quarterly and individually on each job, is a critical, often overlooked tool. During expansion, "cash" should be a key component of every discussion point, from bid day to project start to project completion. Successful firms emphasize receivable collection more than unsuccessful firms and have key people outside of the accounts receivable department involved in the collection process.

Increasing overhead expense in anticipation of more work can be a mistake. Rather, while difficult, contractors that set overhead for a worst-case scenario and ramp up when backlogs actually increase reap the benefits. If paying bonuses to key employees, attempt to do so on a combination of individual job results and overall firm results.

Surety underwriters, agents and your banking professionals often request a plan toward earnings retention, which is critical in achieving goals in an expanding market. Sureties often see contractors withdraw or bonus out all profit during good times, only to wish the money was later there to help cover overhead when the construction cycle changes. Resist the temptation to divert money from the business to sources and ventures unrelated to construction. You can never have enough cash, but if you feel you do, invest in the business.

During an expansion, stay true to the plans, procedures and controls that have led to success and enabled you to capitalize on the upcoming increase in construction spending. Build up your balance sheet as a cushion during the good times, as the only certainty in construction is that times will eventually change. The great firms make money at varying sales volumes and during every construction cycle. ♦



## Performance and Payment Bonds: Mitigating Risk in Construction

By Robert Duke, General Counsel, The Surety & Fidelity Association of America

**When a developer hired a contractor to build a hotel on the East Coast**, the developer required that the contractor furnish performance and payment bonds for the \$15-million project. During construction, the contractor's finances dried up, and the contractor had to file for bankruptcy. Because the contractor was bonded, the surety took over the project and hired a replacement contractor, enabling construction to finish on time. Not only did the surety rescue the hotel project, but it also arranged for the contractor's two other ongoing projects (a credit union and a high school) to be completed as well.

Another well-established contractor incurred an \$11-million loss over two years on a \$60-million hotel project. The future of the contractor and the completion of the hotel and six other bonded projects were at risk. The surety determined that the contractor's financial problems were not related to its performance and provided financial assistance to the contractor so that it could complete the projects.

Construction is a risky business. Unlike other business transactions where the supplier or vendor knows what its costs will be, a contractor's delivery of a building or other facility is based on only an estimate of expected costs. In addition, construction costs can be affected by many variables, such as staff turnover, ownership succession, weather, differing site conditions, change orders and work stoppages. Construction contracts also are distinctively risky because no two projects are the same. The contractor's profitability and cash flow are affected by altered estimates, which can affect the contractor's financial health and threaten its existence, possibly leading to an unfinished project as well as unpaid subcontractors and suppliers.

Statistics help illuminate the special risks the construction industry faces. A publication released by The Governing Institute in collaboration with The Surety & Fidelity Association of America states, "Research conducted between 2013 and 2015 found that contractors have a failure rate of approximately 29 percent, meaning that one in four of these businesses will fail, leaving unfinished small- and large-scale construction contracts in their wake."

In light of the risks of construction, the federal government and all 50 states require that construction contracts of a certain size be bonded. For example, at the federal level, the Miller Act and related regulations require that construction contracts of \$150,000 or more be secured with a performance bond and a payment bond. Legislators have determined that it is sound public policy to protect taxpayers against the excess costs of defaulted construction projects.

A performance bond provides assurance that the project will be performed in accordance with the terms and conditions of the contract. A performance bond helps to provide the project owner and lender the certainty that qualified contractors are hired to perform the work, and second, that financial protection is available in the event the contractors fail.

Payment bonds provide subcontractors and suppliers payment security. Subcontractors and suppliers that have not been paid the amounts due by the contractor can seek financial recovery under the payment bond. With respect to private projects, a payment bond helps assure the owner that the property (collateral for the construction loan) will not be burdened with mechanics liens.

Performance and payment bonds provide the project owner two forms

of protection. The first form of protection is prequalification. That is, a surety provides a bond only to a contractor that it has determined is, in the surety's estimation, capable of performing the work and meeting its payment obligations. This involves the surety's review of the financial strength and capabilities of the contractor in determining whether to provide a bond.

In the event of the contractor's default, the surety steps in to provide the second benefit of the bond, which is financial protection. Typically, the amount of the performance bond is 100% of the original contract price, and the amount of the payment bond is 100% of the contract price. Thus, 200% of the contract price is available to satisfy the contractor's defaulted obligations. The remedies to a default typically are set forth in the bond form.

Lastly, the surety can provide benefits unknown to the project owner, even when the project is not in default to assure the continued operation of the contractor. For example, a surety, in order to avoid the contractor going into default, may provide financing to the contractor to meet payroll. This ensures that the laborers will show up on the job to continue the work.

As the governmental entities and taxpayers prepare for the possibility of increased infrastructure spending, surety bonds should play an essential part to provide critical security. The risk management benefits of bonding are indisputable. Over the past 15 years, sureties have paid nearly \$12 billion under performance and payment bonds that have ensured that contractors stay afloat and that projects are able to be completed in a timely manner. Performance and payment bonds should be essential tools in the risk management toolbox for project owners in the construction industry. ♦

# Strength. Service. Surety.

SureTec is now Markel Surety, and in many ways, it is business as usual—same team, same locations, same products. We now have the resources of a Fortune 500 company (Markel Corporation – “MKL” on the NYSE) which is good for us, our professional surety producers and independent agents, and their clients. We are excited about the future and look forward to partnering with you.

[markelcorp.com](http://markelcorp.com) | [markelsurety.com](http://markelsurety.com)

Markel Surety's products and services are in partnership with Markel Specialty, a business division of Markel Service Incorporated. Contracts are underwritten by one or more Markel insurance companies. Terms and conditions may vary.





**Because no detail is too small**

### **Project Advisory Solutions for Reducing Construction Risks**

Building Envelopes • Structural Systems • MEP Systems • Grading and Drainage • Utilities  
Design Documentation • Constructability • Quality Control Plans • In-place Work • Site Safety

Now the company that helps you resolve claims and disputes can also help you minimize risks at each phase of construction. With attention to detail and expertise in development, design, construction, and claim avoidance solutions, our team of architects, engineers, and building consultants can help you complete the most challenging projects on time and on budget.





## Small and Emerging Contractors: I Won, Now What?

### Creating a Sustainable Plan and Avoiding Default

By Josh Penwell, Vice President of Contract Underwriting, Merchants Bonding Co.

**That feeling of elation when a contractor wins the bid** on that big job can quickly turn to panic without a good plan in place. Contractor default can inflict large losses on everyone involved. This is why surety bonds are used to secure the successful outcome of a project. Almost all public construction projects and many private projects are backed by surety bonds.

The key for a contractor to execute a profitable project is to properly evaluate and mitigate risk. This can sometimes be a difficult task with projects increasing in size and complexity. It is imperative for a construction company to be surrounded by a solid team of advisors in order to sustain profitability.

That team includes a professional surety agent, a surety underwriter, a banker that understands the needs of contractors and a construction-oriented certified public accountant (CPA). The team will provide advice on key financial decisions, project selection, subcontractor prequalifications, succession planning and many more components of your business.

Your surety team is going to discuss avoiding the most common causes of contractor failure—especially the internal factors that the construction company can control. Three situations that sureties see often are:

1. Pursuing work in a new and unknown geographic territory.

2. Going into new lines of construction.

3. Large increases in job size. Often these larger projects have complexities that were not part of the smaller contracts the company is used to.

There are many other causes of contractor failure, such as the lack of a succession/continuity plan when something catastrophic happens to the construction company owner, or personal issues, such as divorce; but they can all be avoided by working with your surety professionals. A team of trusted advisors will set a construction company on the right path to long-term success. ♦

WHAT MAKES YOUR  
**SURETY NEEDS**  
UNIQUE?

OUR  
**SPECIALISTS KNOW.**

Find out more.  
[theguaranteus.com](http://theguaranteus.com)



Excellence, Expertise, Experience ...  
Every time





# Connecting Capabilities to Build the Future



**AMERICAN GLOBAL**

American Global is a full service surety and insurance construction broker. We focus on supporting the insurance, surety, and risk management needs of our clients while also providing added value as a trusted advisor.

**Expect More From Your Broker.**

[www.americanglobal.com](http://www.americanglobal.com)