The Southern Agency
Insurance & Bonds

## Construction Contract Bonds

Surety Bonds provide certainty in construction activity. In fact the word “surety” is rooted in the Latin word “secures” which means secure. Construction work performed for a governmental body virtually always requires bonding. If bonds were not required, the mayor could give construction contracts to his brother, the barber. The surety bond protects the taxpayer. Proper underwriting of the bonding company helps assure that only qualified contractors will be awarded the work. Bonds are optional on commercial work for private owners.

The contract bond <u>guarantees</u> that the work will be performed in accordance with the plans and specifications and that all material and labor bills will be paid. Contract bonds are separated into “Bid Bonds,” “Performance Bonds,” “Payment Bonds,” “Labor and Material” and perhaps “Maintenance Bonds.” This Guide to Placing your construction contract bonds should be helpful to you if you are seeking bonds.

**Three Parties to a Bond**
The bonded contractor is called the “Principal.” The owner is called the “Obligee” and the bonding company is called the “Surety.” The surety responds to the default of the bonded contractor (principal) and satisfies the contractor’s obligation to the owner (obligee).

**Bid Bond Begins the Process**
The Bid Bond is a prequalification or screening device that is evidence to the owner that the surety is satisfied that the contractor can perform the job at hand. This bond should only be posted by contractors that are earnest about performing the job in which they are bidding. This bond absolutely obligates the contractor both financially and to performance.

The Bid Bond is normally in the amount of five-percent (5%) of the bid amount; however, Federal contracts require a twenty-percent (20%) Bid Bond but shall not exceed $3 million. Bid specifications normally allow an option for a certified check with the contractor’s bid in lieu of a Bid Bond. A contractor should not risk putting up a certified check unless he is assured in writing from the bonding agent that the final bonds (Performance and Payment bond) will be issued.

The guarantee of the Bid Bond is that if the contractor is low bidder, the Performance and Payment Bonds will be provided. If these bonds are not issued, the contractor is responsible for the monetary difference between his low bid and the next bid, not to exceed the amount of the Bid Bond. This financial guarantee purpose is to cover the expense to the owner to re-bid the job if the contractor can not (or will not) provide the final bonds.

Should the contractor not be able to furnish the final bonds or refuse to honor the bid, the Principal (contractor) will be required to pay the Obligee (typically the owner) for the spread between his low bid and the second bidder. The bonding company will forfeit the bond value and seek to obtain recovery from the contractor through a process called "subrogation." Forfeiting a bid bond amount is uncommon but the exposure does exist.

**Whistle-stop**: Do not put up a check (in lieu of a bid bond) unless you are certain that you qualify for a Performance Bond. Before putting up a certified check, get in writing that the final bonds will be provided.

**Spread of Bids**

A situation that occasionally causes a contractor to keep from signing a contract or bonding company from providing the final Performance and Payment Bond is a huge difference in bids caused by a bad mistake. Once a contractor has bid a job, the surety underwriter would like to receive a copy of the "bid tabs" that show the spread between his bid and the other contractors' bids. The reason for this information is that other bids are an indication what other contractors consider the proper amount to make a profit. If the client's bid is "in line," this is an indication that the job will be profitable.

**Performance, Maintenance & Payment Bonds**

The Performance Bond assures the owner that the contractor will perform and complete the work in compliance with the contract specification provision. The bond is evidence that the surety company has done the "due diligence" on behalf of the owner. In a sense, the surety company is paid to do the due diligence. The bond guarantees a one year maintenance, or a separate Maintenance Bond is included.

The Maintenance Bond guarantees the contractor will return to correct latent defects in materials or workmanship for a period of time, normally one year. There is no additional premium unless the guarantee goes beyond the normal one year premium.

**Warning Flag**

Sureties reluctantly extend the maintenance period to two years, but resist a longer period. Bonding companies charge for the extra year. Contractor increase its bid price to cover the cost for an additional year of maintaining a completed project.

The Payment Bond, also known as Labor & Material Bond, assures that the contractor's obligation to the suppliers, subcontractors and workers will be paid. The bond guarantees that this work will be delivered free of liens or encumbrances from suppliers or subcontractors. If either bond is defaulted, the bonding company is called in to take over the job, otherwise the bond is "null and void."

Generally, only the owner has a right against the Performance Bond and Maintenance Bond. Different parties such as suppliers and subcontractors have recourse against a Payment Bond.

**Bond Form Requirement**

The specified bond forms that are to be used are often contained in the contract documents in the project manual. Sometimes these forms have language that the contractor's surety will not approve. Like for example, a requirement to provide a five-year maintenance period after the work was finished.

The bond forms that cause concerns to the surety companies are ones that stray from the spirit of the construction contract. Simply stated, the bond should guarantee the requirements in the contract – nothing more, nothing less! BEWARE! There are many rattle snakes in the bid package.

> Real World Example: A contractor was successful bidder to build an airport hanger in the South. The owner placed in the Project Manual an obscure bond form that essentially placed the contractor in default with virtually any misunderstanding, even if there were no financial damages to the owner. The obligations in the bond form were far in excess of customary language that was fair and just. After the contractor spent many hours of justifying to the bonding company that every precaution was in place to eliminate fear of default, the bonding company reluctantly issued the bond.

Many contracts require certain bond forms. Typically the bond forms are standard forms. These include the forms provided by individual surety companies, the AGC contract bond forms (Associated General Contractors of America) and the AIA contract bond forms (American Institute of Architects).

The surety needs to receive copies of the bond forms and to be aware of all provisions in advance of the bid. Each bond form has its own personality. Some forms are stronger than others, and that is why there may be some heart burn with the bonding company!

> **Whistle-stop**: Before the bid, the contractor should forward a copy of the bond form included in contract documents to the agent of the Surety Company. This will eliminate misunderstandings and will create trust between the underwriter and contractor. A contractor that keeps the underwriter informed will always be favored.

**Power of Attorney**

When the bond is issued, the agent must attach a document called a "Power of Attorney" to the Bond. This standard document is the surety companies' authorization for the agent to issue the bond and act on its behalf. The Power of Attorney should be dated the same date the bond was dated.

> Real World Example: One of my clients bid a job for the State of Tennessee. It was the low bid by almost $9,000. After the contractor and estimator celebrated the anticipated award, they were notified that they would not be awarded the job because the Power of Attorney was not dated. The moral to the story is GET YOUR POWER OF ATTORNEY DATED!!

**Treasury List**

When a contract bond for Federal work is issued, the Federal government requires that the surety company be approved by the U.S. Department of Treasury. This requirement from the U. S. government basically disallows small underperforming surety companies from issuing bonds on any Federal job. In other words, the Federal government wants assurance that there will be zero problems getting paid by a bonding company should there be a claim.

Additionally, when Federal jobs are bonded, the surety companies providing bonds must be within their underwriting limit. This bonding limit is based on the financial strength of the surety company as determined by the Department of Treasury. Surety companies cannot issue bonds over their limit; however, they can issue bonds on a joint basis with other sureties.

> **Whistle-stop:** If a contractor is considering a Federal job that must be bonded (typically any job over $100,000 for the federal government must be bonded), the contractor should check with his agent to make sure the surety bond limit is adequate. Also, that the surety is on the Treasury List.

**Benefits to the Contractor**
The contractor receives indirect benefits from the bond which is to make money off of the bonded jobs. The bond identifies the contractor as a strong contractor in the marketplace and gains instant credibility. When the surety company establishes a bond for a contractor, the surety is basically saying to everyone that they believe that the contractor has the resources to handle the job.
**Benefits to the Bonding Company**
Surety companies benefit from the profits made from bonding good contractors. An insurance company's surety department is generally the most profitable department. The insurance company protects those profits by only bonding those contractors that have demonstrated that they will perform the work as obligated.

**Contract Bond Underwriting**
The bonding companies underwrite the bonds to make certain that they are comfortable with the contractor. Most Surety companies are interested in bonding contractors who exhibit adequate experience, a good reputation, satisfactory bill paying habits, and sufficient working capital for the desired bond and other work-on-hand.

When a bonding company "underwrites" bonds for a contractor, they want to know that a contractor has what it takes to perform his obligation. They need to know the contractor's strengths and weaknesses.

**Three "C's" of Bonding**
Surety Underwriters analyze the contractor with the principles summarized as the "Three C's of Bonding:" Character, Capital & Capacity.

i. <u>Character</u>: It is the make-up of a contractor. Will he stand firm against the unexpected contingencies or will he wiggle out and run for the high weeds? This is a judgment call of the underwriter after personally meeting the contractor, smells his breath for liquor and looks in his eyes to see if he has shifty eyes – so to speak. Is there history of bankruptcies, improper shortcuts, compromised debts, extravagancies, etc? If there is a problem with the contractor's reputation for honesty, the bonding company will seldom proceed with considering the remaining criteria. There are ways to strengthen some deficiencies, but there are few ways to correct a serious character problem.

ii. <u>Capital</u>: A contractor may be a most honest person, but if he or she does not have working capital, the bonded job could be jeopardized. How much working capital is needed? A "break even" job and work program needs 10% of the work-on-hand because of the retainage withheld. Net worth is needed to absorb an unexpected loss, an underperforming job and even uninsured insurance claims. A banking relationship and the ability to borrow necessary funds is essential.

iii. <u>Capacity</u>: The bonded contractor must possess the necessary experience and knowledge to perform the prospective job as well as other work-on-hand. Background, equipment and personnel are a few important aspects that determines the capacity of the contractor to perform work as contracted for. A past history of fulfilling comparable jobs is an excellent indication of the contractor's capacity.

**What a surety will need…**

Because the underwriting departments at the Surety companies require certain information to obtain surety credit, your agent will need to collect certain documents, applications, and information. The agent and contractor must meet to develop information, get a feel of the operations and communicate what will be needed for approval by the surety. This application process can be very labor intensive and often times, once completed, the paper may be several inches thick. The items that will be needed are:

- A cover letter to the surety underwriter that includes:
  - information on the ownership and percentage owned
  - history of the operation
  - a list of prior surety companies (if any) and the reason for leaving
  - a description of the work planned
  - information on the territory of operation
  - information on whether the work will be self performed or through subcontractors
  - if subs will be used, list the qualifications and how long these subcontractors have been used
  - a listing of the top jobs completed over the past three to five years (include names of the owners, architects, contact phone numbers, contract amount and profit margin)
  - Communicate to the bonding company the understanding of the seriousness of the obligation in the bonding relationship and the importance of finishing the job in a timely manner.

- Résumé on the owners and key personnel.

- Brochure on the company; if available.

- Photos of some of the finished past projects.

- Provide an application for Surety credit, typically called a Contractor Information Report. The information on the application may even be duplication of information provided elsewhere.

- Furnish a business plan to include strategy, goals, objectives, anticipated volume of work and anticipated profits. The plan should show how to achieve the goals.

- Certificate of Insurance on all of the insurance policies listing the Surety company also as a Certificate Holder.

- Copy of contract documents on the specific job to be bonded showing the scope of the contractor's obligation.

- Bid tabs on previously bid jobs that represent the type of work to be bonded. This may help the potential surety companies how your previously bid jobs compared to other contractors (bids).

- Financial Statements on both the business and the owners of the construction company. These statements should include the last three year-end financial statements prepared externally by a CPA using AICPA guidelines, preferably on a Percentage of Completion Basis of Accounting. (more on this below)

- Personal and Company tax returns for the past three years.

- Financial statements on any affiliated or subsidiary businesses.

- Bank letter(s) reflecting banking relationship outlining the terms, conditions, lines of credit, outstanding loans, average daily balances, etc.

- Letters of recommendation from owners for whom work was previously performed. The letters should include information about the type and contract amount of work performed, when the work was performed and the quality of the work completed, etc.

- Letters from suppliers who have extended credit. These letters should include information such as timeliness of payment and the amount of credit extended.

- A Schedule of Uncompleted Work that is concurrent with the fiscal year end report or the interim statement. This is also called a "work-on-hand schedule." Different bonding companies want the document to state the amount contracted for, the type of work, amount billed, job cost incurred, future cost to complete, estimated profit, and the projected completion date.

- A current "work-on-hand schedule"

- Verification of the owner(s) Life Insurance in the event of death that would protect the business and provide funds, at a minimum, for the company to finish the work-on-hand and the work contracted to do.

- Copy of the Buy-Sell Agreement between the owner(s) of the business showing succession planning in the event of the death, disability, or business dissolution.

- An Indemnity Agreement signed by the owners and their spouses.

And finally, invite the bond underwriter to visit the contractor (and key personnel, if possible) in the contractor's domain if possible. First hand knowledge of contractor's operations may mean the difference between a bond denial – or a bond approval. It creates a long term relationship between the contractor and bonding company.

**Help the Underwriter say: "Yes"**

A complete submission will make a difference in a "yes" and "no" decision from the surety company. The more professional a contractor and agent's submission is to the underwriter, the more likely the bond will be accepted. Remember too, the less time the surety underwriter must spend, the quicker the turnaround time will be on the bond decision.

**Time Line for a Decision**
After the contractor "bears his sole" to the surety and makes application with the complete information to the bond underwriter, a decision is generally very prompt. An offer to extend surety credit will either be given or the bond declined. These decisions normally take several days and even weeks depending on the surety company's backlog of other applications, etc. Do not be frustrated with the process and the time it takes to receive an answer from the surety company.

**Financial Statements**
While financial statements are important to a banker and bonding company, the statements must first be meaningful to the contractor. Let the CPA help you interpret the figures presented so you can react quickly to adverse trends. Different bonding companies will require different type of financial statements. Contractor should get his agent to discuss with his accountant the type financial presentation needed. The very best is a CPA Audit. The least favored presentation is when an accountant compiles the financial records given him by a contractor that was pulled out of a shoe box or hip pocket. When a financial statement is not a CPA Audited statement, substantial verification of assets and liabilities is required. Historically, surety losses stem from reliance upon misleading and inaccurate financial reports.

**Three Type Financial Statements**
There are three types of financial statements that a CPA can prepare for a business. They are Compilation (in-house), Reviewed and Audited. Typically, the CPA's statement could be on a Compilation format for contractor's seeking bonds less than $250,000. For bonds more than $250,000 but less than $1,000,000, a Reviewed statement is typically needed. Bonds of more than $1,000,000, an Audited statement is generally needed. These requirements, of course, are different from surety company to surety company.

If the last year-end statement is more than six months old, prepare a six month interim report. This may be prepared in-house following the format used at fiscal year-end by the outside accountant.

**Percentage of Completion**
Generally, the Percentage of Completion format of accounting will better help the surety underwriter determines the financial position of the contractor. The financial picture is greatly distorted if not on a Percentage of Completion basis. There are instances of advance payments made by the owner to the contractor even before work had started. If the funds were deposited into the bank and then a financial statement was prepared, there would be a great distortion unless it was prepared on a Percentage of Completion basis.

An actual example: A contractor was awarded a $10,000,000 job and billed the owner $1,000,000 the first month for a $3,000 plaque honoring the government officials that had been instrumental in the construction project. The contractor's bank account had the $1,000,000 of funds in the bank account just in time for the year-end financial statement. Quite a distortion of the contractor's real financial condition!

**Infrequent Bond Needs**
A contractor may have an infrequent bond need and should be nimble when the need does arise. For these type operations, the contractor's financial statements could be on a "compilation" basis, especially if he is only seeking smaller bonds infrequently. This presentation generally satisfies the surety underwriter if the financial statement contains schedules of receivables, payables, and cash in bank that can be verified.

A contractor needs to be mindful of the type financial statement required by his surety company. The requirement differs from one Surety Company to another. Additionally, the job size and work-on-hand can also dictate the type financial presentation.

**Line-of-Credit**
Often times a contractor is not seeking a bond on a specific job but wants to plan for future jobs. What is needed is called a "Bond Line of Credit." This is actually the very best position a contractor and surety can have because there is no drop-dead timeline forcing a quick decision.

**Whistle-stop**: Once the Surety has established a Bond Line of Credit, a contractor should respect the "Four Corners" of the credit extension and only focus on those jobs that are within this limit.

When an extension of Surety Credit is given to a contractor, it is often expressed as a "Single Job Limit" and a "Total Program." The Single Job is the MAXIMUM that the surety is extending for any one particular job while the Total Program is the aggregate accumulation of ALL work in the contractor's backlog (bonded and un-bonded). When a contractor's work-on-hand increases, bonding capacity decreases.

Sometimes the contractor is granted only single job bonds as the need arises. Agent's communication is essential to an ambitious new and growing contractor about what is needed to get bonds. Failure to communicate has been one of the greatest breakdowns. This failure has caused embarrassment to contractors and a great waste of time.

Once the bonding limit is established, a bonding company will consider increasing the bond limit after some experience has been established. To increase the bonding limit, the contractor may have to increase net worth, retain more earnings, improve credit worthiness, injection of more capital into the company (and keep it there), etc.

**Bank Letters of Credit**
Bank Letters of Credit may be needed to supplement the working capital. It is important however that the Bank Letter of Credit actually add liquidity instead of merely shifting liquidity around. If fixed assets such as real estate are the basis of the Letter of Credit collateral, working capital is added to the contractor's financial statement.

**Requirement to Bond Subcontractors**
A contractor may have opportunities to bid a job that is larger than he has previously performed. The bonding company may need extra financial security. Contactors that use subcontractors may increase their bond capacity if they require subcontractors to bond each job. When a contractor subs out a large portion of the work, the bonding company may require the subcontractors to be bonded.

**Job Size Consideration**
A surety bond underwriter will be concerned when a contractor wishes to perform a job that is larger than the largest job completed in the past. Many underwriters will apply a "rule of thumb" when establishing extensions of surety credit. For example, one underwriter will not generally extend surety credit on any job that is fifty-percent more than that of the largest job completed in the past. This "rule of thumb" is established because the surety is concerned with the contractor's capacity to perform such work.

Another concern is sufficient working capital in the company. Surety companies' traditional "rule of thumb" is for the contractor to always maintain at least 10% working capital for the new job plus the total outstanding backlog. These concerns may be justified and may not be, but the burden lies on the back of the contractor to prove to the bonding company that he has sufficient funds to perform such work, survive a bad job, delays in payment from the owner, etc.

**Cash in Lieu of Bond**
Contractors that have to post final bonds quickly and can not get the bond underwritten in time for contract signing deadline may post money to the owners in the value of the contract price. When a contractor does post cash to the owner in lieu of the final bonds, the owner will typically release the funds dollar-for-dollar as the contractor performs the work. A small amount may be retained to cover a one year maintenance period.

**Specialty Bond Companies**
There are specialty bonding companies that contractors turn to when they do not qualify for bonds through "standard" or "preferred" surety bonding companies. These bonding arrangements often require heavy collateral. This collateral arrangement is a percentage of the bond amount and in the form of an Irrevocable Standby Letter of Credit from a bank, an assignment of a certificate of deposit (CD), etc. These bond programs also come with more expensive bond premium.

With these type bonds, be very careful to not default and cause trouble to the bonding company. You never want the black luxury sedan to drive up occupied by men in black suits as they may be heartless!

**Whistle-stop**: A contractor should have his agent exhaust all efforts in getting a standard / preferred bond (with no collateral requirement) due to larger premiums and the tying up of collateral.

**Specialty Bonding Companies Collateral – THE IRREVOCABLE LETTERS OF CREDIT**
There are several types of "irrevocable letters of credit." The one that most often is requested is an "evergreen letter." This letter of credit is one that most banks do not want to release because the requirement to renew the letter. Be sure to get a copy of the sample letter from a potential surety should they require such collateral and share it with your banker.

**Small Business Administration (SBA) Bond Program**
The Federal government recognized that small contractors had difficulty in obtaining bonds; so, in 1971 the SBA established a program for small contractors. The government assumes 90% of the risk and the surety retains 10%. The surety keeps 80% of the premium and remits 20% to the SBA.

**Small Bond Express Programs**
An emerging trend in the bonding business is that surety companies have established “Bond Express” programs that do not even require financial statements. These programs are for smaller bond obligations. That are usually less than $250,000 for single job limits. The underwriting decision is based primarily on the credit score of the contractor (the higher the credit score the better). This program requires a very limited amount of information by the surety.

**Be Persistent**
If the surety company says that they do not feel comfortable with the amount of the bond requested, have your agent evaluate the presentation to make sure that nothing was left out. Ask the agent to discuss with the surety underwriter what exactly was the cause for concern. Work toward resolving these issues. It could be something as simple as misinformation or clarifying a misunderstanding.

Have your agent contact other bonding companies if you are still declined. If your company is declined by the standard / preferred markets, have your agent submit the application to the specialty bonding companies. There may be a surety willing to commit to you with heavy collateral. There are many companies willing to bond good contractors. Some are more lineate than others.

**Respect the Surety’s Judgment**
Historically, the surety companies have learned what is successful and what is not. Do not “burn bridges” with the industry. Be patient and work on the business conditions that caused the declination and reapply after the problem has been resolved. The corporate surety business is over a century old. Their principles have proven correct and have worked through the years. A bonding company’s declination may be a blessing to a contractor! I remember this point so well because one client told me “that the best job that I ever got was the one that I never got…”

Remember that these extensions of bond credit are not any different than that of a bank’s extension of credit. I believe that a surety bond is more hazardous. The extension of surety credit generally has no collateral AND the bonding company is required to complete the defaulted work.

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| **Whistle-stop**: If you have been turned down for bonding by several companies, it may be a blessing. You may have avoided a devastating unprofitable job. Do not let a rejection cloud your mind. Make plans for the future to improve your situation. |

**Indemnification to Bonding Company**
Without a signed Indemnity Agreement the surety will not normally issue any bonds. This agreement is normally signed on both a corporate level by officers and personally by the owners and their spouses. <u>The document should be signed only after the indemnifiers understand that the document absolutely commits them to the bonding company until all bonded jobs are complete.</u> If the contractor defaults on it’s contracted obligation and the bonding company has to respond, the bonding company will look to the Indemnitor(s) for reimbursement.

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| **Whistle-stop**: The signing of this Indemnity Agreement is perhaps the most serious document the contractor will ever sign. A contractor should not commit to the bonding company ALL of his assets if he does not want to risk it all. |

Surety companies usually require the Indemnity Agreement of all major owners and their spouses. The spouses guarantee is necessary because normally the husband and wife's net worth are tied together. This indemnity agreement eliminates the possibility of the owner transferring assets into the spouse's name and control. Additionally, the surety company wants the spouse to know that the contractor has committed all of the family assets to the surety. This commitment from the spouse assures the bonding company that these assets will be controlled by the surety in the event of a death, disability or financial set back of the contractor; at least until jobs are finished and bills are paid. Should a contractor default on a bonded job and the Surety respond, the Surety shall also require all legal fees be paid by the Principal (contractor) and Indemnitors.

**Whistle-stop**: A contractor should avoid a bond claim as this will eliminate the contractor's ability to secure future bonds. All assets will be tied up to the bonding company after a bond claim and the assets can be sold for pennies on the dollar to make the bonding company whole again.

Numerous conversations arise with contractors about the Indemnity Agreement. Many contractors have told me that they have been advised by their attorney "not to sign the indemnity." This is not generally an option if the contractor wants a bond. The attorneys that express this to contractors believe that they are serving the contractor, but fail to understand the bonding companies need for this protection. In a semi-serious way, my dad always told his clients to let their "attorney get the bonds" for them knowing the attorney would be faced with the same requirement. Good Luck! That statement always seemed to work for him.

Real World Example: A contractor had two jobs, one was a bonded backed by personal indemnity and the other un-bonded. This contractor diverted contract monies from the un-bonded job to cover the losses of the bonded job. This tactic was just one measure used by an unscrupulous contractor to avoid the loss of his personal assets. The point being, the Indemnity Agreement is very significant.

There are limited exceptions to the indemnity requirement, and those are usually reserved for minority owners (less than 10% ownership), large public corporations, etc. Because the indemnity agreements literally allow the bonding company to "strip the shoes off the baby's feet," there are isolated cases that the indemnity can be limited. This limited indemnity is reserved for unique cases. For example if bonding company extends surety credit to a multi-millionaire contractor, he might be able to insulate part of his assets to a certain percentage of the total "bond program."

If the contractor does not wish to sign the indemnity agreement both corporately or personally, why should the bonding company commit to bond the contractor? If the contractor does not believe in the jobs that they are committed to, why should the surety company?

**Whistle-stop**: A contractor must understand the indemnity agreement before signing. It commits the contractor to completing the job without default. If not, the bonding company must step in and will force the contractor and Indemnitor(s) to repay the surety plus legal fees and interest.

## In the Event of Default

If the Principal (contractor) is in default with the Obligee (owner), one of several things may occur. One of the options is that the Surety selects another contractor to perform the work. Another allows the Obligee to select another contractor to wrap up the work. Either way, both the Principal and the Surety are jointly responsible.

## Pitfalls and Problems

Contractors face problems at every turn. Bad weather, strikes, uninsured mishaps, increased costs of material are just a few. Here are three major pitfalls and a collections of additional pitfalls to avoid.

### Pitfall # 1 - Inadequate Insurance

A contractor should review the construction specifications to make sure that the insurance requirements are reasonable (just like the bond requirements) and can be fulfilled by his insurance agent. Exorbitant and large insurance limit requirements are often overlooked. Many times a contract has already been signed only to learn that the limits of insurance were so large that the contractor's profits decreased by insurance costs alone.

If the contract has a Design-Build exposure, Professional Liability Insurance (Errors & Omissions) should be maintained by the contractor; otherwise, the design risk may shift back to the bond.

Some of the strongest contractors become un-bondable because of financial losses due to errors, accidents, or omissions that were not covered by their insurance contracts, particularly in the General Liability area. Even if the contentions against the contactor are bogus and unfounded, the Certified Public Accountant® (CPA®) must disclose such potential litigation on the financial statements that may jeopardize bond credit.

<u>A contractor must understand his insurance coverage, and the insurance agent must understand the contractor's exposure.</u> For example if a contractor built a $1,000,000 building that burned down after the work was completed (and accepted by the owner) that was caused by an electrical subcontractor and there was an exclusion for work completed on behalf of a subcontractor, there may be a void of coverage. Be sure to evaluate this exclusion. Deal ONLY with insured subcontractors with flawless reputations. The agent can properly council the contractor in this area. On our website we have information on how to properly contract with subcontractors—with the right risk transfer components.

### Pitfall # 2 – Owner Out of Money!

Many good contractors have been forced into bankruptcy because the owner ran out of money and did not pay the contractor for the work performed. Receive a guarantee from a responsible third party such as a bank or architect that funds have been escrowed to pay the contractor. It is ironic that the bonding company must underwrite both the obligee (owner) and the principal (contractor).

> **Whistle-stop:** On private work, make certain the job is well financed. What is the financial rating of the bank supplying the owner's money? (Your bonding company can check out the bank's rating and financials.) Has the financing been approved by the loan committee? Did you get it in writing?

### Pitfall # 3 – Unreasonable Maintenance Period

A construction contract maintenance period is normally one year; however, if this period is longer, the bonding company will be concerned. But most of all, contractors should be outraged to be obligated to maintain a structure for more than one year. Long term warranties such as on roofing, appliances, heating and air conditioning systems and windows should be furnished by the manufacturer.

## Additional Pitfalls and Advice from Surety Underwriters

>avoid becoming over-extended by taking on too much work<

>know what is happening by making frequent visits to job sites<

>pay all bills promptly as committed<

>avoid being spread too thin territorially<

>have competent staff and superintendents<

>keep in-house financial statements up-to-date<

>have the CPA keep financial statements current<

>hire a construction oriented CPA who understands the type financial reports the Surety is looking for<

>have an accounting system that coordinates with the CPA<

>avoid speculative projects and stick to what you are capable of doing<

>make "change orders" in writing and bill out the cost immediately<

>make sure design drawings and specifications are complete and adequate<

>rushed work due to a severe deadline may lead to costly defects and possibly injury to workers<

>avoid contracts with unreasonable penalties<

>check for environmental hazards on or near the jobsite<

>require bonds of principal subcontractors<

>move quickly and legally against subcontractors that fail to properly perform<

>make certain that lien waivers are given by subcontractors before each draw is paid to the subcontractors<

> stop work and properly protect your rights when the owner defaults on payments/draws<

>make sure the work stoppage is not interpreted as "abandoned the construction" which could void Builders Risk coverage<

>sell off excess equipment to eliminate cost and maintenance expense<

>don't buy equipment if more economical to rent<

**Job Progress Reports**
So that the surety company may keep up with the progress of the bonded job, the surety may ask the owner for reports on the progress of the work called Progress Reports. These requests normally include estimated percentages of completion, payments made to the contractor, etc.

**Bond Premium**
Once the surety bonds have been approved, the underwriter will submit a commitment to the agent. Part of the commitment will be a premium breakdown. The premiums will be based off of the financial condition of the contractor, the judgment of the underwriter, the class/type of contractor and work being performed. The premium may depend on whether the surety has received any collateral protection such as Certificates of Deposit, irrevocable letters of credit, etc.

Some contractors may have an average rate of 1.5% and while others may bear a rate of over 4% to 5%. The higher the premium rate, generally the higher the risk. While the bond premium is paid by the contractor, this premium is always loaded into the cost of the job and ultimately passed on to the owner. This truth makes bonding so unique in that the contractor pays the premium but the owner gets the protection!

The bond premium will eventually be based on the final contract price at job completion. "Change orders" may increase or decrease the original contract amount. An additional premium is billed or a return premium refunded.

**Conclusion**
The contractor is always responsible for its obligations under the contract. The bonding company guarantees that the work will be complete under a Performance Bond and bills paid under a Labor and Material Bond; however, ultimately, the bonded contractor (Principal) will be held accountable for the obligation of the Surety to the owner (Obligee).

**Whistle-stop**: A bond is NOT insurance against a bad job. The contractor must finish the job as obligated to do in the construction contract or reimburse the surety if it has to complete the work.

A contractor is asking that the surety stand in his place in the event that he can not perform the work. It is a situation where a contractor can not ask any one else to do what a bonding company can do. The commitment of the bonding company is enormous. A contractor must respect this relationship and protect it with all his might.

Stay in contact with the surety through the insurance agent on a very proactive basis. Establish goals and communicate these goals to the surety underwriter. Underwriters want to bond good contractors that are pro-active. The bond underwriter will become an integral part of the construction company.

For more information or to make application for insurance or bonding, please contact:
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