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SECURING SURETY BONDS DEMANDS PROFESSIONAL TEAMWORK

A U.S. Census Bureau report placed the value of all commercial/industrial construction projects in 2007 at approximately \$673 billion. For many contractors, capturing a share of that work was predicated on their ability to secure a surety bond. According to preliminary estimates by the reinsurance community, approximately \$5.3 billion in surety bonds were written in 2007.

There are federal, state and local regulations requiring bonds for construction projects. At the federal level, the Miller Act requires bonds on all federal construction projects exceeding \$100,000. Federal thresholds, however, vary by state. In New York, for example, many federal agencies require bonds on projects valued at \$250,000 or more. The states,

operating under what are commonly referred to as the “Little Miller Acts,” have various value thresholds for which bonds are required. For many, that threshold has been increased from \$50,000 to \$250,000. Local municipalities also have their own established thresholds.

Obtaining a surety bond is a complex process that every construction business owner should fully understand. This includes recognizing the importance of involving key professionals from the outset; specifically, the surety bond producer and a Certified Public Accountant (CPA). Each has a specific, yet overlapping role, and the information each prepares for the bond application must be cohesive and consistent in order to meet the surety company’s qualifying criteria for a bond.

Surety Bonds 101

Contrary to common misconception, a surety bond is not an insurance policy, nor is it a substitute for insurance. It does not provide coverage for liability or property damages and will not cover personal injuries or property damages sustained due to contractor negligence. Nor will a surety bond afford protection to a project owner against claims filed by a contractor. A surety bond is an agreement between three parties:

- ▶ The contractor (referred to as the *principal* in surety bond documents)
- ▶ The project owner (referred to as the *obligee*)
- ▶ The surety bonding company (also known as the *surety*).

In this agreement, the surety promises to pay the project owner if the contractor fails to fulfill its obligations under the construction contract.

The reason some confuse surety bonds with insurance policies is that many surety companies are subsidiaries or divisions of insurance companies. Like insurance, a surety bond is a risk management tool.

These are the three primary types of surety bonds:

- (1) A *bid bond* assures that a bid represents a good faith offer at which the contractor agrees to enter the contract and provide the necessary performance and payment bonds for the project.
- (2) A *performance bond* protects the project owner from financial loss if the contractors fail to perform according to the contract terms.
- (3) A *payment bond* (also known as a labor and material bond) assures that the contractor will pay subcontractors, laborers and suppliers involved in the project and specified in the surety bond application. It guarantees a lien-free project.

The contractor pays the premium for the performance and payment bonds and includes the bonding fees in the bid. Typically, the premium ranges from 1 to 3 percent of the contract price.

The surety producer assists the contractor in understanding the different types of bonds and their functions and helps the contractor secure the right bond from the right surety company.

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The Roles of the Surety Producer and CPA

An experienced surety bond producer knows that not all surety companies are created equal. They each serve different markets and have various underwriting criteria. A surety producer with strong credentials and a broad network of surety companies can effectively match a contractor's needs to a surety company that caters to a particular contractor profile and/or project category. This may not seem particularly important to very large, well-established and recognized contractors, but for the majority of construction business owners whose companies fall within the broader middle-market and small business category, this is critical to securing a bond.

Also vital to the bond procurement process is having the right accountant on board. If the contractor does not have a qualified accountant who is experienced in construction, the surety bond producer can recommend a CPA who specializes in this industry. The accountant should not only bring an in-depth understanding of the construction industry and its various operational and financial nuances; he/she should also have a thorough understanding of the preferences and requirements of surety companies (i.e., financials, including: balance sheets, income statements, accounts

payable and receivable schedules, expenses, work-in-progress schedules, etc.). The CPA should also be capable of preparing the three different categories of financial statements required—a compilation, review and audit—using accepted accounting and auditing standards that will sustain third-party verification and substantiation.

The surety bond application, specifically the financial information prepared by the CPA, must be consistent with the company's other financial statements and documentation (e.g., information on tax returns, bank loans and lines of credit applications, etc.). If it isn't consistent, the surety company could easily reject the application on the basis of inconsistent financials. Working collaboratively on behalf of their mutual client, the surety bond producer and CPA can take the necessary precautions and perform the essential checks and balances to make sure that a consistent, accurate picture of the contractor's financials is presented.

Once the surety bond producer has obtained all of the underwriting information, he/she assumes responsibility for marketing the contractor's account. This role is vital, particularly in marketplaces like New York City and other major metropolitan areas where in-depth knowledge of the unique challenges of the construction/bond

■■■ Owner's Headaches

environment is necessary. The producer's relationship with surety companies is also extremely important. Contractors should understand that the producers they select are a direct reflection on them, and the producer's knowledge, experience and track record are just as important as their credibility with surety companies, who want to deal with someone they trust and respect.

Consistent Financials, Business Plan, References

Along with presenting accurate and consistent financials, surety companies require several other items from contractors seeking a surety bond. These items include: biographical profiles of the construction business's executives, as well as a business plan outlining the company's target markets, geographic territory, methods of operation, competitive situation and growth objectives. In addition, many

sureties will ask for a business continuity and/or succession plan presenting the contractor's plan of continuing in the event that a key executive should become disabled or die. They also may ask to see a key man life insurance policy on the principals naming the construction company as the beneficiary. The surety will also ask to see documentation for bank lines of credit to address potential cash flow problems. Finally, the surety will expect to receive references from third parties with whom the contractor worked on prior projects (i.e., owners for whom projects were successfully completed, subcontractors, architects, engineers, etc.).

By allowing the surety producer and CPA to effectively lead in the surety bond procurement process, contractors can position their businesses for a wider range of projects and gain credibility with surety companies. These companies will recognize the

contractors as knowledgeable business owners who avail themselves of expert advice and present their application for bonds in a professional, complete manner.

The business owner will also begin to establish his/her own relationships with surety companies based on professionalism and open and honest communication, backed by the advice and support of an experienced, credible surety producer and CPA.

For more information on the surety bond process, check out these two excellent resources: National Association of Surety Bond Producers (www.nasbp.org) and The Surety & Fidelity Association of America (www.surety.org). ■

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