

Washington Building Congress Presents:

Bonding Basics & Tips

Presented by:

Emily A. Brennan, Esq.

HMS Insurance Associates, Inc.



Shannon Briglia, Esq.

BrigliaMcLaughlin, PLLC



Outline

Understanding Surety Credit

Maximizing Surety Credit & Bonding Capacity

The Indemnity Agreement

The Claims Process

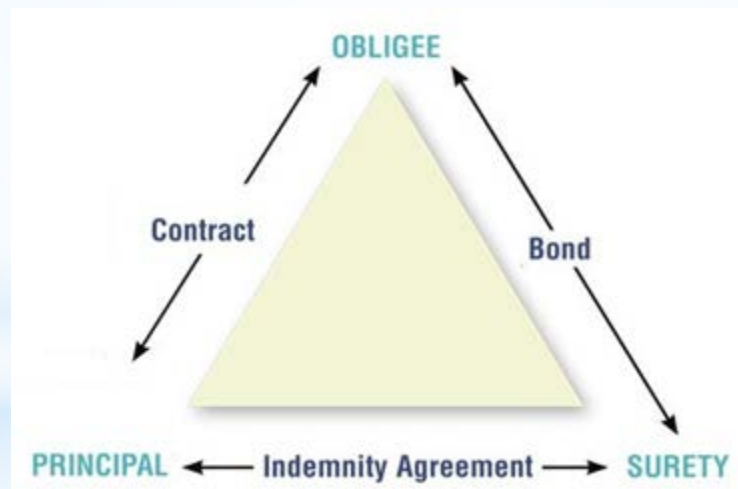


Understanding Surety Credit

What is a Surety Bond?

A surety bond is a guarantee of the contractor's performance

The Surety Relationship



Understanding Surety Credit

Why would an Owner require a Surety Bond?

- Bond acts as “pre-qualification” of the contractor’s ability. The surety underwriting process determines competency of the contractor.
- Ensures the owner will receive a finished project at the negotiated price, according to the plans, specs and contract requirements. (Performance Bond)
- Ensures the owner that all project subcontractors, suppliers and vendors are paid for services and materials provided on the project. (Payment Bond)
- May be required by Federal or State statute

Understanding Surety Credit

Types of Construction Surety Bonds

- Bid Bond
 - Guarantees owner that low bidder will enter into a contract for the bid price
 - If contractor defaults, surety pays difference between 1st and 2nd bid or maximum penal sum (5% or 10% of bid amount)
- Performance Bond
 - Guarantees that contractor will complete the project per the plans and specifications in the time allotted.
 - If contractor defaults, surety options typically include completion of the project or tender of penal sum

Understanding Surety Credit

Types of Construction Surety Bonds

- Payment Bond
 - Guarantees owner that contractor will pay subcontractors and suppliers on the project; lien-free project
 - If contractor defaults, surety pays the undisputed amount due to the bond claimant
- Maintenance Bond
 - Guarantees against faulty workmanship or materials; typically one-year following date of final acceptance.
 - If contractor defaults, surety options typically include repair or completion of the work, or reimbursement of costs to owner

Understanding Surety Credit

What is the process to obtain a Surety Bond?

- Surety Agent Selection
 - Organizational Information
 - Financial Statements
 - Current backlog & Work-in-Process
 - Personal Financial Statements
 - Banking relationship
 - Review of Internal Controls

Understanding Surety Credit

What is the process to obtain a Surety Bond?

- Underwriting by Surety Company
 - Full Financial Analysis
 - Indemnity Determination
 - Make Reference Calls (i.e. suppliers, vendors)
 - Dun & Bradstreet, Personal Credit Reports
 - Meet with Contractor

Understanding Surety Credit

What is the process to obtain a Surety Bond?

- Establishment of the Surety - Principal Relationship
 - Enter into General Indemnity Agreement
 - Define Single and Aggregate Bonding Limits & Rates
 - Requirement for Annual Updates & Meetings
 - Information Required with Bond Requests
 - Financial Updates
 - Project-Specific Information

Maximizing Surety Credit

Three C's of Underwriting

Cash

- Ability to finance the bonded project
- Ability to absorb a loss

Character

- Does s/he stand behind his company?
- Honest, good reputation, etc.

Capacity

- Skill/experience to perform bonded project
- Equipment and infrastructure to perform bonded project

Maximizing Surety Credit

Most Important Financial Measure

Ten times adjusted working capital = total bonded program

- Certain current assets dropped below the line
- “No, your stockholder note is not working capital!”
- “Ten times adjusted net worth” for heavy equipment contractors
- Deferred tax liability can greatly impact this equation

Maximizing Surety Credit

Positive

- Stability of revenues/growth
- Consistent profitability
- Retention of profits in company
- Accurate job-costing
- Maintain a line of credit
- Quick-turning A/P
- Collection of A/R
- Timely and accurate financial reporting

Negative

- Significant fluctuations of sales and/or gross profit margins
- Significant distributions to stockholders/members
- No line of credit in place, or borrowing to max capacity
- Working Capital is comprised of significant underbillings
- Poor cash flow
- Lag on financial reporting

Maximizing Surety Credit

Think Like an Underwriter

Know your Financial Position

- Be able to track and explain contract profit margins
- Be able to show proper estimates without project profit fade
- Track and explain “underbillings” on projects
- Know the run-off rate (i.e. completion times)

Know your Contract Risks

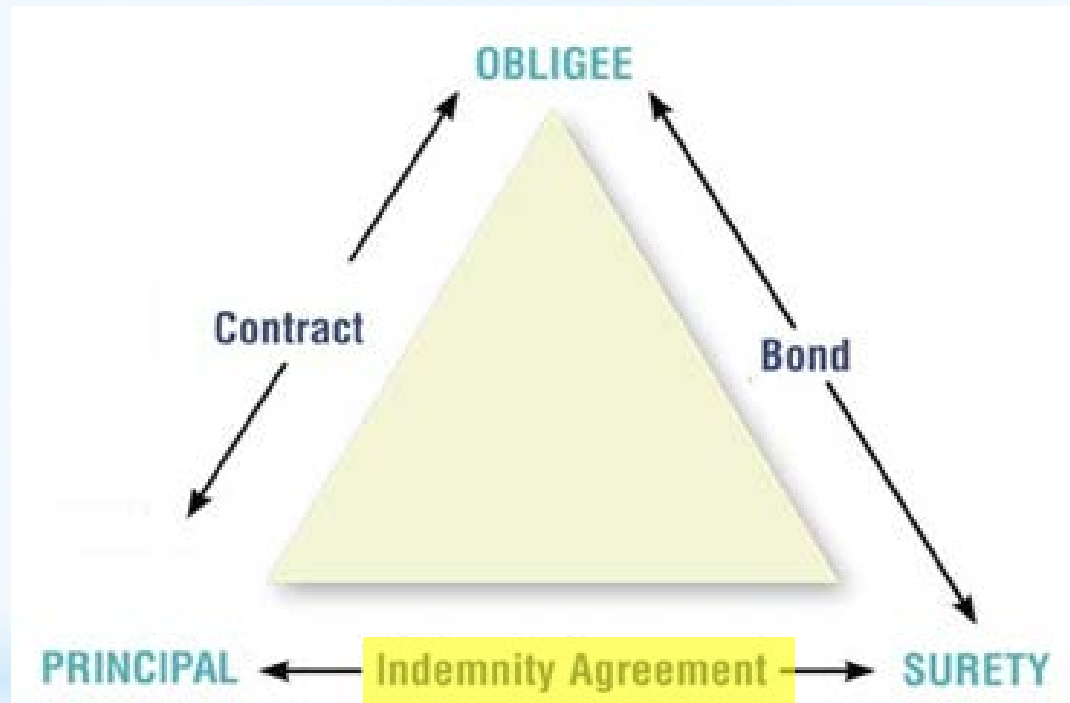
- Be able to explain specific risks on projects (i.e. phased, etc.)
- RTFC (i.e. payment terms, warranty periods, LD’s, etc.)
- Experience with owner/GC and Subcontractors

Maximizing Surety Credit

Think Like an Underwriter

- Partner with Construction-Oriented Professionals - DO THIS NOW
 - CPA's
 - Attorneys
 - Bankers
 - Insurance and Bond Agents

The Indemnity Agreement



The Indemnity Agreement

- Necessary part of the underwriting process to support surety expectation of no loss
- Creates rights and obligations between surety and principal
- Written document, signed under seal, by principal and other indemnitors
- Little to no negotiation of terms
- Universally literally enforced by courts

The Indemnity Agreement

- Establishes bonded contracts as trust funds or held in trust for benefit of Surety
- Creates a security interest in bonded contract funds which may be recorded as UCC-1
- Gives surety rights relating back to date of bonds
- Surety not obligated to issue bonds
- Joint and several liability
- Surety's right to access books and records

The Indemnity Agreement

Surety's rights upon default

- Indemnification against liability and loss
- Assignment of principal's rights in bonded contracts
- Right to be "placed in funds" - collateral
- Take over equipment and materials and complete
- May direct obligee to pay surety contract proceeds
- Broad rights to compromise claims against the bond and affirmative claims on bonded project

The Indemnity Agreement

- Waiver of homestead
- Broad recovery of Surety's attorneys' fees
- Recovery of unpaid premiums
- Principal can challenge Surety's decision to compromise claim only by posting collateral
- Termination by Indemnitor of obligation for new bonds
 - Prospective
 - Must comply with the requirements for termination of obligation to be effective

The Indemnity Agreement

- Importance comes into play when there is a payment bond claim or performance default
 - Will support Surety's response to claim
 - Provides Surety's discretion to resolve claims
 - Supports lawsuit against indemnitors - successive suits also possible
 - Personal jurisdiction and venue provisions
 - Waiver of jury trial
 - Standards of proof - exercise of good faith business judgment and use of affidavit to establish prima facie case

The Claims Process

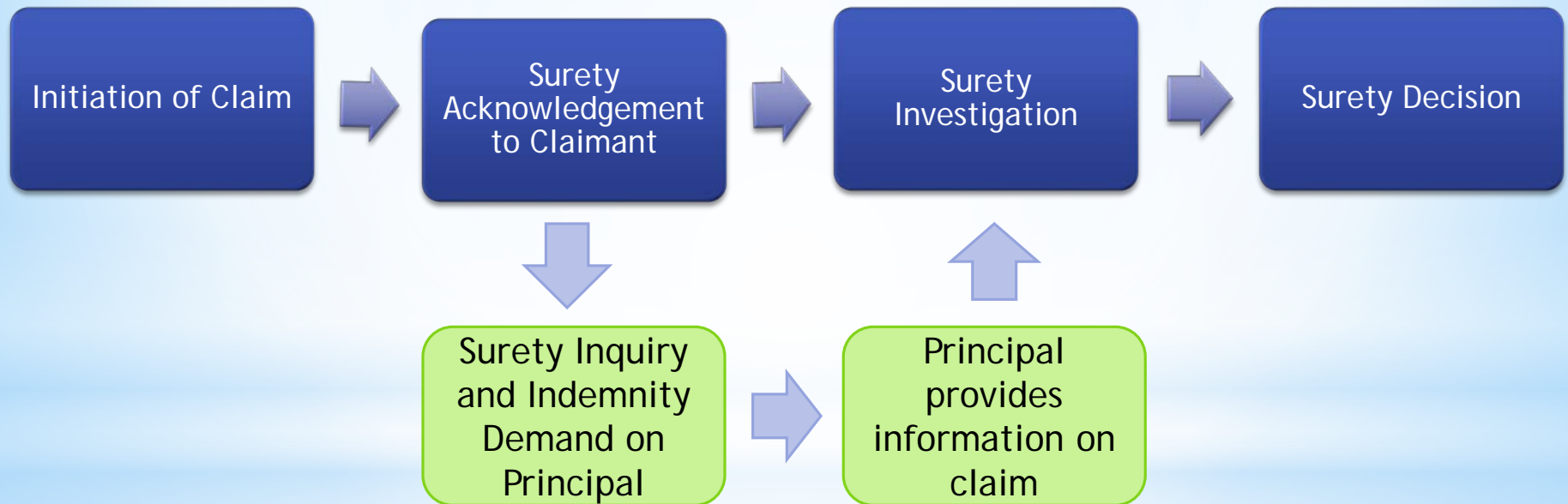
Payment Bond Claims

- Subcontractor or Supplier claims nonpayment on a bonded job

Performance Bond Claims

- Obligee declares a default in performance
- Typically prior to substantial completion

The Claims Process - Payment Bond Claims



The Claims Process - Payment Bond Claims

Pay

- Release or Settlement Agreement
- Indemnity Demand to recover payment and fees/costs

Partial
Payment

- Partial Release
- Further investigation and evaluation of disputed portion
- Final decision on disputed portion

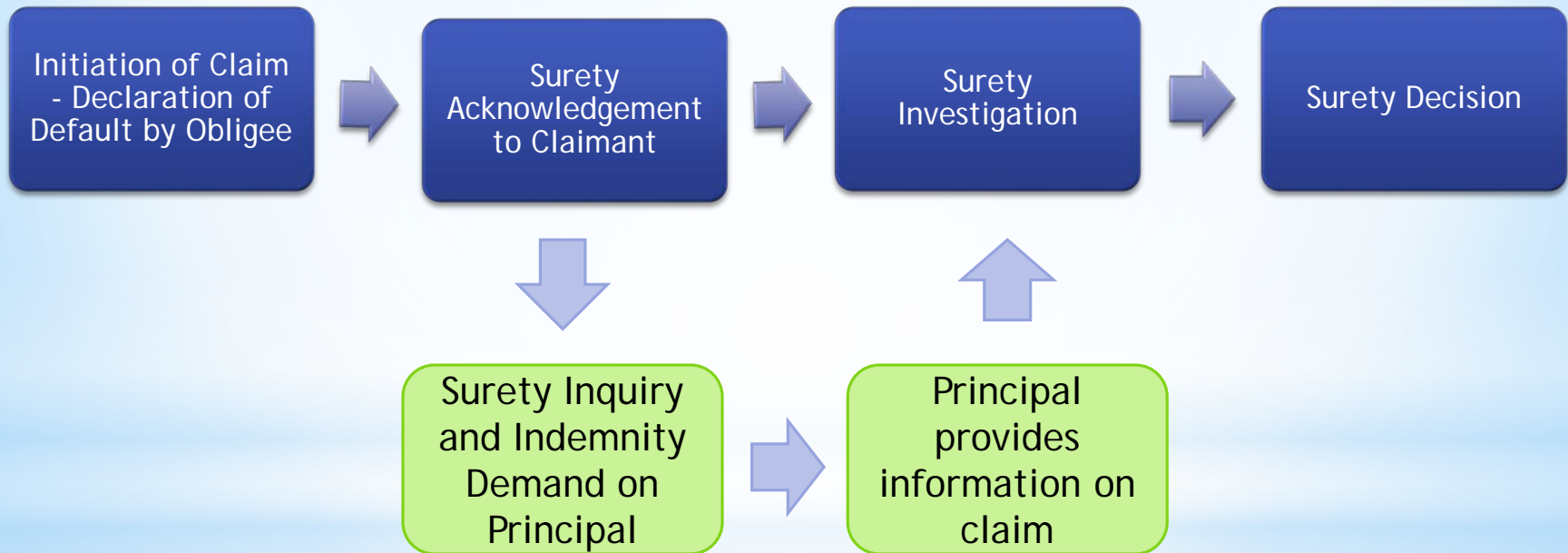
Deny

- Lawsuit
- Tender of defense to Principal - Surety may retain own counsel
- Surety defends using its own retained counsel

The Claims Process - Payment Bond Claims

- Administering payment bond claims is costly
- You can mitigate these costs by
 - Cooperating with the Surety during the investigation
 - Proactively aiding or anticipating the investigation
 - Placing the surety in funds, and taking over the claims process - gaining control over what is paid to claimants and minimizing transaction costs

The Claims Process - Performance Bond Claims



The Claims Process - Performance Bond Claims

Deny

- Indemnity Demand to protect against anticipated action by obligee
- Defend inevitable lawsuit by obligee

Perform

- Takeover
- Finance to Completion
- Tender

Do
Nothing

- Defend inevitable lawsuit by obligee

The Claims Process - Performance Bond Claims

- Administering performance bond claims is costly
- You can mitigate these costs by:
 - Cooperating with the Surety during the investigation
 - Proactively aiding or anticipating the investigation
 - Figuring out a way to complete the project or cure the default to regain control over completion costs

Lessons Learned

- Access to surety credit opens up new markets and opportunities, but carries risks, especially for small and mid-size companies through the indemnity agreement
- Good internal controls are the keys to success
- Read your contracts & bond forms; know your risks
- Surround yourself with competent people
 - Internally (job site personnel, PM's, etc.)
 - Externally (CPA's, Lawyers, Bankers, Insurance Professionals)
- Stick to what you know (scope & geography)

Emily A. Brennan, Esq.
HMS Insurance Associates, Inc.

ebrennan@hmsia.com

p. 443-632-3330



Shannon Briglia, Esq.
BrigliaMcLaughlin, PLLC

sbriglia@brigliaw.com

p. 703.506.1990



Contact Information