Job Ready Guide

Construction risk management

Reducing risk with surety bonding

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Why risk it?

While the economy continues its slow recovery, the construction industry is still feeling the after effects of a long and deep recession. Financial pressures forced a higher number of subcontractors and general contractors to default on contract obligations during the economic slowdown. Many of those companies went out of business. As a result, today's project owners are more cautious than ever and transferring more risk to their GCs through the use of surety bonds.

As a contractor, you also need to protect yourself from this increasing risk. Understanding your obligations as a bond holder as well as how to use bonds to transfer your own risks is critical in today's construction environment.

In this Job Ready Guide we'll explore:

- The importance of the contract in meeting bond obligations.
- Ways to transfer your own risk by requiring bonds from subcontractor and suppliers.
- How to use surety services to prequalify subcontractors.
- How to handle bond defaults.
- Why you need to check into your sub's bonding company.

20 percent of all construction contractors in 2009 were out of business by 2011—leading to a more cautious construction environment today.

Source: Construction Executive, 10th Annual Contractors Guide to Surety Bonding, Bizminer data, November 2012

Know your contract responsibility

One of your biggest risks as a contractor is entering into a contract that you have not thoroughly read, understood, and felt you could deliver on. This is especially important when your customer is requiring you to provide performance and payment bonds. Why is thorough contract review more critical than ever?

Owners are pushing risk to GCs. Today's more cautious owners are adding new terms to contracts that can further increase your risk if you are the general contractor. For example, many owners now push to limit the time sureties can investigate and respond to a claim. And it is common for changes to be made to the bond form, which extends the time period claims can be filed. When reviewing any contract, pay special attention to start and completion dates, warranty periods, dispute resolutions, and liquidated damages that could result in daily payment penalties.

GCs are transferring risk to subs. If you are a subcontractor entering into a contract with a GC, you must take other factors into consideration. The GC's subcontract can include "flow down" or "pass through" clauses that transfer contract obligations made between the GC and owner to you. These obligations likely include insurance, indemnity, payment, warranties, extras, liquidated damages, and dispute resolution. If you sign a contract with these unrestricted clauses, you are accepting whatever a general contractor has agreed to with the owner.

You have a lot at stake. Once you sign a contract and provide the bonds, you are locked into all terms and conditions of that contract. Most sureties require you to provide both corporate and personal indemnity commitments in order to secure bonds, so not only are you putting your business at risk, your personal assets are at risk as well if you default.

Many contractors are pushing back on unacceptable contract terms, either by not accepting a job or proposing revisions. Construction bond agents will encourage you to review the contract and can assist in helping you understand the terms and conditions of a contract, including identifying any areas of concern. You should also seek professional advice from your legal counsel before signing any contract.

Reducing your risk with bonds

Subcontractors are critical to the success of a project. Problems with just one sub can delay the work of others, potentially derailing the entire project. Surety bonds can assist in managing this risk.

In a survey conducted by construction management consultant FMI, 62% of surety providers report seeing an increase in the number of general contractors requiring performance bonds from their subcontractors. That trend will likely continue as surety providers encourage or even require prime contractors to obtain bond guarantees from their subs as a way to reduce the GC's own bond exposure.

Risk transfer

Contract surety bonds shift the risk of a subcontractor's failure to one or more surety companies. The bonding process assures the general contractor that a sub will perform all terms and conditions of the contract or other measures will be taken to protect the GC. This assurance is provided using two types of bonds:

- **Performance bond** that guarantees the subcontractor will complete the contract according to its terms, including price and time.
- **Payment bond** that guarantees the subcontractor will pay its suppliers and contractors.

Contractors may also want to consider bonding key material suppliers. This is especially important for projects that extend over a long period of time, where price fluctuations could put a financial burden on the contractor. Asking a supplier to provide a bond will reduce both the GC's and subcontractor's risk that the supplier will provide the materials needed to fulfill the contracted obligations.

Subcontractor screening

An added bonus of the bonding process, from a prime contractor's point of view, is the rigorous qualification process subcontractors must go through in order to obtain bonding. Requiring a sub to be bonded, therefore, can help screen out unqualified subcontractors.

Reputable subcontractors, in turn, will not object to being asked to provide surety bonds. In fact, a growing number of subcontractors, looking to expand their ability to get work, are engaging with sureties to build their bonding capacity.

Prime contractors should check a subcontractor's bonding status as a standard part of their prequalification process. Bonding is especially important on large, complex projects or on jobs where a few subs represent proportionally large or critical segments of the work. Some GCs have a formal bonding process with set thresholds for when subcontractors must provide bonding. Always get a copy of the bond paperwork at the beginning of the project before the sub begins work.

When checking a sub’s contract bond, make sure to also check on the reputation and quality of the surety that is backing the bond. Is the surety qualified to write contract bonds? Is the surety licensed in the locations where you do business? Does the surety have a history of successfully working with local contractors? Your own bond agent can assist with verifying the quality of a surety as well as uncovering important information about the sub such as reputation, financial condition, and bonding capacity.

When defaults occur

Actively managing your subcontractors and keeping communication channels open throughout the project is the best way to detect any signs of potential default early and take proactive steps to remedy the situation.

Contractors, however, should also understand what steps they need to take if a bonded sub doesn’t meet obligations. When a subcontractor defaults, there are often critical claim and notice requirements imposed by contract and by law. Working proactively with a lawyer to lay out a contingency plan that you can immediately put into action will save you money and liability exposure and keep the job running.

It’s important to note that sureties are not arbitrators of disputes that often occur during a project. Bonds are designed to remedy defaults only. Sureties can handle a default in several different ways, but the preferred solution is to hire another contractor to complete the job. Two other, less used options are to finance the original contractor in order to meet contract obligations or pay a financial settlement to the bond obligee.

What to look for in a surety

Whether you are looking for a surety that can bond your own company or you are checking on your subcontractor's surety, make sure you do your due diligence. Several sources are available that rate sureties. The most popular is A.M. Best, a credit rating agency serving the insurance industry.

Another useful source is the U.S. Department of the Treasury, which publishes an annual list of sureties that are qualified to write bonds. Often referred to as the "T" list, it tells you which states the surety is licensed to do business in and the surety's underwriting limitations.

Most sureties distribute bonds through agents (also known as brokers or producers). A professional bond agent is your guide through the bonding process, helping you to select and build a relationship with a surety that best fits your needs. So it's also important to select a surety agent that you can trust has your best interest in mind. Look for an agent who:

- Has a reputation for integrity and quality service.
- Is experienced in the construction industry.
- Understands construction contracts, finance, strategic planning, and successful management practices.
- Has built solid relationships with respected surety underwriters.
- Is actively involved in local and national construction industry associations.

Other resources available to check into surety companies and agents are the U.S. Small Business Administration, Surety & Fidelity Association of America, and National Association of Surety Bond Producers.

Summary

A reputable surety agent and company can be a key partner in helping you manage your risk. They can also serve as key company advisors, helping you to spot issues, improve processes, and overall build a stronger business.

About the authors

Kelly Niemela is the surety bond manager at LaPorte & Associates and has more than 20 years of surety experience. She is enthusiastic and enjoys being a part of the construction industry and success of her clients. Kelly strives to successfully complete all aspects of surety underwriting and use the fundamentals to analyze, evaluate, and arrive at final decisions. Her professional, reliable service translates into a firm's ability to maximize profits and establish long-term relationships. Her first priority is dedication to the clients she represents.

Deb Carpenter-Beck is a writer and marketer with more than 25 years of experience in the construction and real estate industries. She often writes about technology and best practices and is passionate about helping contractors and real estate professionals achieve their business goals. You can follow her blog posts at www.blog.sagecre.com and on Twitter @SageDebCB.

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Sources: The Insco Dico Group, Five Reasons for Bonding Subcontractors

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