# SURETY BOND BASICS FOR CONTRACTORS

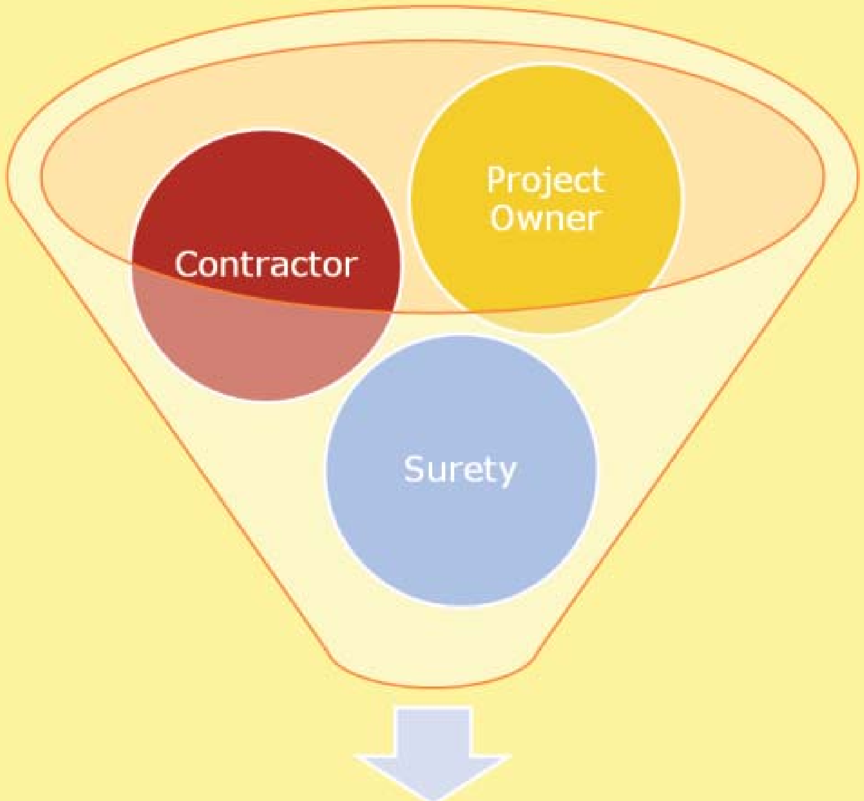
Presented by: McKnight Insurance Services

# In this Presentation…

You will obtain an understanding of the following:

- Definition and Benefits of Surety Bonds
- Types of Surety Bonds
- Obtaining a Bond
- Costs of Bonds
- Managing and Tracking Bonds
- Reasons Why Subcontractors Fail
- Signs of Subcontractor Failure
- Avoiding Default
- The Claims Process
- Establishing an In-house Bonding Policy

# Definition and Benefits of Surety Bonds




Contractor Surety Bond

# Definition and Benefits of Surety Bonds

- Relieves the project owner of risks of financial loss as a result of liens for unpaid subcontractors and suppliers. They also protect taxpayer money for public projects.
- Transition between construction of the site and permanent financing is smooth because there are no liens.
- Surety company can offer assistance such as technical, managerial and financial – to move the project along and reduce the chance of default (project failure).
- Surety company arranges for project completion, if the contractor defaults.

# Types of Surety Bonds

- Bid Bond – provides financial assurance that the bid has been submitted in good faith. The contractor intends to fulfill his/her responsibilities at the price bid and will provide necessary performance and payment bonds.
- Performance Bond – protects the project owner from financial loss if the contractor fails to perform the duties outlined in the contract.
- Payment Bond – guarantees that the contractor will pay subcontractors and laborers, and for supplies relating to the project at hand.

# Obtaining a Bond

## Prequalification

- Capacity to perform tasks
- Financial strength
- Company history
- Organizational structure
- Continuation plans
- References
- Current work in progress
- Good character
- Experience in matching contract obligations
- Financial stability
- Good credit history
- Solid banking relationship
- Line of credit
- Has equipment necessary to carry out the contract

# Obtaining a Bond

- Prior to a bid, lead contractors can require a letter from the subcontractor's surety regarding their ability to provide bonds on the project. If a subcontractor is not starting the project right away, then the surety company may not issue a commitment letter. In that case, the lead contractor may have to accept a letter indicating the potential availability of bonds – subject to the surety's underwriting conditions.
- Bonds are only available for qualified subcontractors – some are available for niche markets.
- The U.S. Small Business Administration Surety Bond Guarantee Program guarantees performance and payment bonds issued by surety companies to young companies who have a hard time obtaining surety bonds.

# Costs of Bonds

**Bid Bond**

- No charge or minimal charge

**Performance Bond**

- 0.5 to 2 percent of contract price

**Payment Bond**

- Included with performance bond cost

# Costs of Bonds

Utilize these resources when receiving bids:

- U.S. Department of Treasury:
  www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm
- State Insurance Department:
  www.naic.org/state_web_map.htm
- Surety Information Office:
  http://sio.org or call 202-686-7463

# Managing and Tracking Bonds

- Surety communicates to the lead contractor via job status reports. This leads to the discovery of early warnings of potentially hazardous problems.
- Disputes over responsibilities for the scope of contracts are common and most sureties will offer assistance in resolving these problems (though they have no legal obligation to do so).
- If the surety is not able to assist in resolving a situation, default may result. If this is the case, the lead contractor must file a formal declaration of default to the surety company.

# Reasons Why Subcontractors Fail

Managerial problems

- Inadequate accounting, financial or project management systems
- Management or personnel changes or complications
- Business strategy changes
- Rapid over-expansion and growth
- Poor owner, lead contractor or project selection

# Reasons Why Subcontractors Fail

Labor and material problems

- Shortage of labor and materials
- Unrecovered cost escalations

# Reasons Why Subcontractors Fail

## Uncontrollable factors

- Lead contractor on a different job does not pay
- Severe weather hindrances
- Unexpected economic failures
- Difficult contract terms or working environment
- Changes in the job site conditions
- Death, illness or departure of necessary employees
- Labor shortages or difficulties
- Material and equipment shortages or price increases

# Signs of Failure

## Financial signs of failure

- Tight cash flow
- Receivables turning over slowly
- Bills are past due
- Vendors demand cash on delivery (COD) for supplies and materials
- Bank lines of credit are borrowed to the limit and credit

## Business plan problems

- No contingency plans, goals or objectives
- No road map for future plans

# Signs of Failure

Project management problems

- Inadequate project supervision
- Inability to find reasonable prices on change orders or inability to collect on change orders
- Projects are not completed on time
- Projects are moving at a slow pace
- One or more projects has a claim
- Safety violations on the jobsite

# Signs of Failure

## Poor estimating and job cost reporting

- Revenue and profit margins decrease
- Operating losses
- Loss or reduction of bonding capacity
- Contractor bids low to get new work out of desperation

## Communication problems

- Lots of disputes between the contractor and project owner
- Poor communication between management and field workers

## Loss of loyal customers

- Contractor cannot fulfill contracts – jobs are not done in time or within the established budget

# Signs of Failure – Avoid Default

- Establish a good relationship with your producer and surety underwriter
- Manage growth and control overhead
- Communicate with the surety if and when problems arise
- Understand contracts and their language
- Read bond forms and look for difficult or unmanageable terms and conditions
- Verify the surety's licensing abilities by checking with the state insurance department

# Signs of Failure – Avoid Default

- Develop a solid relationship with the surety and remain respectful of their decisions and practices
- Use a construction-oriented CPA
- Have a bank line of credit available to support your business plans
- Conserve capital
- Adjust your overhead

# The Claims Process

To efficiently manage the claims process, a project owner should do the following:

- Verify the validity of the bond before signing the contract
- Notify the surety in case of changes to the contract
- Notify the surety if problems arise immediately
- Allow the contractor time to cure the default before terminating
- Notify the surety company if potential default arises (in writing)
- Request an in-person meeting to discuss complaints
- Provide records to the surety company when going through the claims process

# The Claims Process

If the surety company finds the contractor has defaulted on the project, they may take one of the following actions (dependent on the bond form and facts of the situation):

- Assume responsibility for completing any remaining work by hiring a completion contractor
- Tender a new contractor to the project owner
- Retain the original contractor and provide trained workers and financial help to finish the job
- Reimburse the project owner for the amount needed to finish the project (up to the penal sum of the bond)

If the investigation reveals that the contractor is not in default, the surety company is not obligated to act.

# Establishing an In-house Bonding Policy

- Set a limit at which bonds must be required. This may be a dollar amount or a percentage of a contract (Example: all contracts over $25,000 or all subcontracts for 20 percent or more of the overall job).
- Include the following details in your bonding policy:
  - Type and complexity of the job
  - Duration of the contract
  - Bid spread
  - Subcontractor size and reputation
  - Government regulation requirements
  - Subcontractor’s experience with the type of project on the table
  - Subcontractor’s role in the contract
- Once your policy has been established, notify all subcontractors, the surety bond producer and the surety underwriter.

# Questions and Comments

Surety Bonds can be complicated.

Let McKnight Insurance Services help you along the way!

Call

**817-277-6166**

To Speak With a Bonding Expert