



SURETY BONDS—COMMON MISCONCEPTIONS

1. We often hear that sureties never pay losses. Is this true?

From 2002-2013, surety companies have paid a total of over \$13 billion in claims, plus additional billions for claim expenses. A hidden value of the surety product is that often surety companies avert losses by financing contractors through a tough time or negotiating conflicts before they become losses. The only tracking of this involvement is through expenses.

2. Can't an owner prequalify a contractor on its own?

Sureties are in a unique position to prequalify a contractor, as they have access to confidential information that typically is unavailable to a project owner. Generally, a surety has a close, longstanding, confidential relationship with the contractor, its employees, attorney, banker, accountant, and other advisors. Sureties also focus on the entire enterprise not just one specific project. Because of this, the surety has access to detailed financial information, ongoing analyses of organizational strengths and weaknesses, and information on current problems facing the contractor. The surety is in a better position than a project owner to determine if the contractor has the 3 "C"s: Capital (Credit), Capacity (Capability), and Character (Reputation) to be a sustainable contractor. If the surety agrees to support the contractor, it does so expecting that the contractor will fulfill its obligations and never default on a project. If the contractor runs into trouble or defaults during the project, the financial risk is transferred to the surety, whose balance sheet then is at risk. If an owner performs its own prequalification, the burden of project completion falls on the owner, who does not have the resources or expertise to prequalify the contractor as thoroughly as the surety or the funding to pay twice for the project or the expertise to complete the contract.

3. Waiving bonds will help small, emerging and minority contractors, right?

Surety bonds are about supporting sustainable contractors and payment of subcontractors and suppliers. Bonding is established and expands as a contractor grows and succeeds. If bonds are waived, the contractor never gets the thorough review of its business and, moreover, does not get an opportunity to build a successful track record with the surety company. A small company will be much more likely to get support for a small project.

To grow in the arena of public construction, a contractor needs an established relationship with a surety. Even if bonds are waived for specific projects, contractors will need to seek bonding at some point. The later the small contractor is required to enter the bonding world, the harder it will be to gear its business to meet the underwriting standards put in place to ensure only qualified contractors are bonded to complete public projects. These standards also help to ensure the contractor is taking the steps necessary to manage its business correctly and efficiently. In the long run, while waiving bonds might get a contractor one job, it harms small and emerging contractors and suppliers by raising the difficulty of qualifying for their first bonds and substantially increasing their risk of non-payment if they are operating as subcontractors. Since most public works projects cannot be liened, there is no recourse for a subcontractor if a project does not have a bond. If bonds are waived, subs and suppliers will either have to risk losses from non-payment that they cannot afford or not work on the public jobs for which they are best qualified in order to avoid the increased risk of non-payment.

4. Doesn't raising bond thresholds allow small, emerging, and minority contractors access to procurement opportunities?

The goal in bonding is building sustainable contractors by allowing small contractors to build successful portfolios of bonded work. Lower thresholds allow contractors to build relationship with sureties and build capacity earlier in their careers.

Raising bond thresholds increases the risk of non-payment and default, due to the lack of a surety's extensive prequalification process, during which the surety verifies that the contractor is capable of completing the contract and paying its subcontractors, suppliers, and laborers (see #2). Those defaults harm small, emerging, and minority contractors.

5. Can't big construction companies provide parental guarantees that provide exactly the same protection as bonds?

A parental guarantee raises a number of concerns. First, is the parent a shell or LLC that really has no assets? How do subcontractors access a parental guarantee? Are the subcontractors granted claim rights directly against the guarantee? What is the protection for taxpayer dollars? If a contractor fails, it is likely that the parent will have a long line of unsecured creditors pursuing payment of outstanding obligations. As previously mentioned, a surety has a longstanding relationship whereby, upon paying the principal's debts or performing its obligations, it has equitable rights to contract funds that are superior to a bankruptcy trustee. At the end of the day, the parental guarantee most likely provides minimal, if any, guarantee of payment.

6. Aren't big construction companies immune from failure?

Big is big; big does not necessarily mean strong. One only need look back less than 20 years to see a list of well-established and well-respected, large, heavy construction

companies that have filed for bankruptcy—names like Morrison Knudsen (1905-1995), Guy F. Atkinson (1926-1997), and J.A. Jones (1890s-2003). A more recent name is Modern Continental (1967-2008), the largest contractor on the Big Dig. In 2000, Modern Continental was a \$1.3 billion company with over 4,000 employees. While Modern Continental's problems started with a default on a wastewater treatment plant project, the issues it encountered on the Big Dig (including a guilty plea to 39 federal charges) led it to file for bankruptcy in 2008. The successful completion of the Big Dig should be credited to the surety claim department that managed the claims and financed Modern Continental to completion of its projects and ultimately filed a proof of claim in the bankruptcy for hundreds of millions of dollars.

Even more recently, Ballenger Construction Company (1937-2012), a large Texas road contractor, filed for bankruptcy in December 2012 leaving subcontractors, suppliers, and others on 20 bonded transportation projects with a total value of \$356 million in bills. About \$112 million of work remained on the Ballenger contracts when the company went out of business. Ballenger was founded in 1937 and had 550 employees, all of whom were laid off. Ballenger's sureties again are managing the claims and making sure the projects get completed and the subcontractors and suppliers who timely file proper claims are being paid.

7. Bonds are expensive, aren't they?

The premium for a bond is collected only when the contractor wins a bid and is usually reimbursed by the obligee on the first draw. Although surety rates are actuarially based and contemplate the potential for loss, they also act as a fee for the surety's extensive underwriting and prequalification service. Bonds generally run between 0.5% and 3% of the contract price and vary depending on the size and type of project, the contractor's bonding capacity, and whether the Small Business Administration's Surety Bond Guarantee is used (in which case, the cost will be close to 3%). Here is what you get for the price of a bond:

- A very rigorous and thorough prequalification process that looks at the entire business organization of a contractor, not just one project. If bonds are required, all bidders have to go through the prequalification process. Only the successful bidder pays for the premium for the performance and payment bonds, which is paid for by the owner and usually reimbursed to the contractor in its first draw.
- A bid bond, if required, (usually 5-10% of the bid price) to protect the owner or obligee and provide assurance that the contractor is able to enter into the contract at the bid price and provide the requisite performance and payment bonds. If a bidder wins the bid and is unable to enter into the contract, the surety normally pays the difference between that bidder and the next bidder (up to the penal sum of the bond).
- A payment bond with its own bond penalty (usually 100% of the contract price).

- A performance bond with its own bond penalty (usually 100% of the contract price).
- Financial protection and claim service up to the bond penalty for each bond, including the cost of completion of the contract, including the process of finding a replacement contractor, if necessary.
- Monitoring the contractor's work-in-progress and new bid activity to make sure there are no issues with the account and/or execution of the work.

8. If an owner has a good relationship with a contractor and trusts its ability to complete the work based on past experience, the owner doesn't need a bond, does it?

Construction is a risky business. According to BizMiner, one in four contractors fails. No matter an owner's relationship with a contractor, the owner should rely on a surety bond for the best protection on a project. The surety prequalifies the contractor to guarantee, in the surety's opinion, that the contractor has the capital, capacity, and character to complete the project. If the contractor and owner should disagree on contract performance issues and the owner declares the contractor in default on a bonded project, the surety must investigate the claim. If the contractor is found to be in default, depending on the terms of the contract and bond, the surety may:

- Re-let the job for completion;
- Provide a replacement contractor;
- Retain the original contractor, providing trained personnel or financial assistance; or,
- Reimburse the owner the penal sum of the bond.

Without bonding, the project owner absorbs the risk and costs that are associated with a contractor unable to fulfill the contract.

9. Other products provide the same protection as bonds, right?

No other risk management product provides the comprehensive protection performance and payment bonds provide. Others, such as a letter of credit (LOC), may offer access to a small amount of the contract value in the form of cash should the contractor run into trouble on the project; however, the task of administering completion of the contract and raising enough funds for completion is left to the owner. A bank will pay on a LOC upon demand of the holder. The holder or beneficiary, however, must make a demand prior to the expiration date since no funds are available after the expiration date, even for liabilities incurred prior to expiration.

A surety company, on the other hand, is focused on the completion of the contract and has a number of options to assure the contract is completed according to contract terms (see response to question #8). Also, with payment bonds, the surety pays the

rightful claims of certain subcontractors, laborers, and suppliers. In contrast, with a LOC, the owner must determine the validity of claims by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid in addition to covering cost of completion.

Another benefit is that surety credit is balance sheet neutral to the contractor and preserves liquidity that otherwise would be required to support the securitization of the project with a different instrument. This coverage further enhances the contractor's liquidity and increases the likelihood of contract completion, payment of subcontractors and suppliers, and payment of liquidated damages.

10. Isn't access to money the most important consideration in a contractor default?

The most important thing to consider when a contractor defaults is how the contract will be completed. Surety bonds are the only risk management tool that ensures completion, according to terms of the contract and payment of subcontractors and suppliers.

11. Won't subcontractor default insurance provide the same protections as surety bonds?

Subcontractor Default Insurance (SDI) often is often described and marketed as an alternative to performance and payment bonds, but it is merely a traditional insurance policy between the prime contractor and the insurance company. The insured and beneficiary under the policy is the prime contractor and not the owner or the lower-tier subcontractors, suppliers, and laborers. A surety bond is a comprehensive risk transfer mechanism that provides the prequalification of subcontractors according to established criteria, shifts the risk of the principal's default from the obligee (owner) to the surety, and provides 100% payment protection to covered subcontractors and suppliers. Because SDI does not provide payment to subcontractors, the most vulnerable contractors (small, emerging, and minority) are exposed to greater risk.

Furthermore, surety bonds require the surety to manage default situations. With SDI, the general contractor is responsible for handling all aspects of a default situation. The prime contractor is expected to pay all losses initially, then seek reimbursement from the insurer. The effect on the principal's cash flow can have a significant impact on the ability to complete the job and pay its subcontractors. Also, if a subcontractor suffers a loss due to the contractor's failure to pay, he or she has no right to file a claim directly with the insurer. If the prime contractor decides not to, or is unable to, pay a subcontractor, he or she has no recourse to file a claim for the money owed.