SURETY REQUIREMENTS:

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FINDING AND MAINTAINING YOUR SURETY BONDING

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Sureties are obviously very important in the construction world. A surety bond is similar to an insurance policy in that the bond protects a party in the event of a loss. However, there is an important fundamental difference between the two. Unlike an insurance policy, under which the party purchasing the policy is protected from loss, a surety bond is purchased by the principal (the contractor) for the surety to provide a guarantee to the obligee (the owner) that the principal will fulfill its obligations.

Here are the most common types of surety bonds:

- Bid bonds assure the job owner that the contractor will enter into the contract at the price that was bid.
- Performance bonds assure the job owner that the job will get done and that the surety is responsible for ensuring the contract is completed in its entirety and as expected.
- Payment bonds assure the subcontractors and suppliers that they will be paid for their obligations performed under the contract.

A general contractor is required under the Miller Act to obtain, at a minimum, both a performance and payment bond when contracted under the federal government or one of its agencies for at least $100,000. This requirement protects both the owner of the contract and the subcontractors that are hired to perform under the general contractor. Bonds can also be required under private contracts, making surety bonds almost unavoidable.

To outsiders, it may seem that finding the right surety and satisfying it is a hassle to a contractor. However, it is important to note just how valuable the right

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surety can be for a contractor and its successful future. As we outline the process for obtaining bonding, keep in mind that this story does have a happy ending.

A contractor's first step in obtaining a surety bond is to find a trustworthy surety bond producer who acts as an agent between the contractor and surety company. The producer will be in direct contact with underwriters from several different surety companies to identify the right surety company to fit the contractor's unique and specific needs. The type of surety that is sought can vary depending on the types and sizes of jobs performed by the contractor.

Surety underwriter checklist

When the producer finds a surety, there are many different aspects and details of the company on which the surety underwriter will focus when determining whether the contractor is likely to fulfill its obligations under the bond. The contractor needs to first go through a prequalification for bonding, which requires the following.

1. A breakdown of the organization structure of the contractor should include the responsibilities of the company's key employees. An organized and structured company is more attractive to a surety; it demonstrates that controls are in place to help prevent misappropriation of assets or significant issues that could potentially affect the contractor's working capital.
2. A business plan that states the company's objectives, as well as the strategies by which it plans to achieve them, is necessary. The plan also needs to include the type of work that the company is seeking, the geographical region in which its work is done, and potential prospects. The surety would like to know that the contractor has a business model with goals it can reasonably achieve.
3. A description of the company's succession or continuity plan (if any) is essential. This may seem like an unusual request, but this is important to a surety if the company experiences the death of the owner or other key personnel. If the contractor loses someone who is crucial to the everyday activities of the company, that contractor is expected to have a backup plan to continue its business operations and fulfill its current obligations. A life insurance policy on owners or key employees can also be a plus, as it can protect the surety from a loss if the company defaults on its bond.
4. A history of larger jobs that the contractor has completed is expected, as well as a current work in progress schedule that lists the job owner, contract prices, expected gross profit, and approximate completion dates. If the surety is aware of the types of jobs the contractor is able to complete and the margin at which the jobs are completed, it can better understand how the contractor was able to perform on larger jobs in the past.
5. Supporting agreements for the company's revolving line of credit should be provided. Cash flow is arguably the most important financial measurement of a company's success, as a healthy bottom line does not mean anything if the cash is not coming in. Cash flow can be strained for a number of reasons, and the company needs to be able to compensate if these deficits do occur in order to meet its short-term working capital needs.
6. Letters of recommendation should be collected from owners, subcontractors, or engineers with whom the contractor has previously worked. This may almost seem too easy, but if a company has a good relationship with one of its owners or subcontractors, receiving a recommendation from that party can go a very long way in obtaining bonding. Contact information may also be provided when the contractor provides the underwriter with the owners for each outstanding job and its larger historical jobs. Under-

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writers could contact these owners to get a better idea of how well the contractor performed the work and whether it met expectations. Third-party verification of a company's performance could be one of the most valuable tools in assessing its abilities to perform its obligations under future contracts.

Although it was mentioned that cash flow is arguably the most important measurement of a company's financial status, a surety needs a full understanding of all aspects of a company's current and past performances. While cash may be coming in, if the contractor's job costs and overhead are consistently exceeding the revenue it is earning on its work, at some point the cash is going to run dry. The contractor will be expected to provide at least two to three years of prior fiscal year-end financial statements. The surety will also require financial statements that have been given some level of assurance by a CPA.

IF THE CONTRACTOR IS CONSIDERED VERY RISKY DUE TO POOR FINANCIAL PERFORMANCE AND THE UNDERWRITER IS NOT SATISFIED WITH THE COMPANY'S FINANCIAL INFORMATION BUT IS STILL WILLING TO OFFER BONDING, A PERSONAL PROMISSORY AND CASH COLLATERAL MAY BE REQUIRED.

The following types of year-end statements may be provided.

- Audited financial statements: A CPA certifies a professional opinion that the financial statements are in accordance with accounting principles generally accepted in the United States (U.S. GAAP), which is obtained through substantive audit testing and highly effective analytical procedures. This is the highest level of assurance that can be provided on financial statements, and it is generally required by the surety when the contractor is trying to obtain very large federal and state contracts.
- Reviewed financial statements: A CPA will provide limited assurance that the financial statements are in accordance with U.S. GAAP by performing analytical procedures and an inquiry with company management. If the contractor is looking to obtain a bond in excess of $1 million, reviewed financial statements will generally be required by the surety.
- Compiled financial statements: A CPA will provide no assurance regarding whether the financial statements are in accordance with U.S. GAAP; however, the CPA firm will express its independence in the accountant report, which will give the surety minimal assurance. Compiled statements can generally be accepted if the bond limit does not exceed $1 million.

The underwriter may also request interim financial statements quarterly as prepared by management if this is not sufficient. If the contractor is considered very risky due to poor financial performance and the underwriter is not satisfied with the company's financial information but is still willing to offer bonding, a personal promissory and cash collateral may be required. The necessary assets must be in place to guarantee recovery in the event of a loss.

The surety will also require the contractor to sign a personal or corporate indemnity agreement. This will further ensure that the obligee compensates the surety for any losses incurred as a result of failure to fulfill its obligations under the bond. The obligee is expected to pay all damages possible before anything comes out of the surety's pocket.

Surety bonds for small businesses

The checklist that a surety underwriter must go through to offer a bond to a contractor is admittedly tedious; however, there are many contractors who will not meet these requirements and will therefore not be able to obtain bonding through private surety companies. This could be due to the small size of the contractor or the fact that the contractor has not been in business long enough for the surety to gain comfort that it will perform the obligations under the bond. Hope is not lost for these contractors, as the Small Business Administration (SBA) was established to benefit small businesses and give them an opportunity in the marketplace by creating a level playing field. The SBA can guarantee surety bonds for smaller contractors, which gives sureties additional reassurance that they will recover any potential losses under the bond.

SBA bonding can be very beneficial for small contractors hoping to get their names out in the marketplace and compete with larger contractors. To qualify for SBA bonding, a contractor must meet the following criteria.

1. The company must qualify as a small business. The revenue threshold differs depending on the construction specialty performed by the contractor under the SBA size standards, and the size standards vary based on the type of contractor:
   - companies in the business of constructing buildings and heavy/civil engineering construction, whose revenues do not exceed $36.5 million;
   - companies in the business of land subdivision and dredging/service cleanup activities whose revenues do not exceed $27.5 million; and
   - specialty trade contractors whose revenues do not exceed $15 million.
2. Federal contracts pursued under the bond must not exceed $10 million, and nonfederal contracts must not exceed $6.5 million.
3. The company should maintain a line of credit with a reputable bank. The SBA considers the available balance on the line of credit as additional cash for the purposes of calculating working capital. It can be very beneficial to the company to request an increase in its credit line to boost its working capital, which can result in greater bonding limits.

As promised, this story will end on a positive note. While finding and maintaining surety bonding seems like a grueling process (as the surety company must review the contractor's financial data on a constant basis), there are several benefits that can be expected from finding the right surety. First, it is important to note that a good surety bond producer, with whom the contractor has established trust, can make a world of difference in the search. A good relationship with the producer is more likely to result in a good relationship with the surety. When the contractor finds the

right surety, establishing and maintaining a good relationship is crucial. Surety companies are very well connected in the business world with groups such as bankers and accountants, and the surety can be used as a reference for a contractor to get connected with these groups. The surety must understand the needs and objectives of the business and can then point the contractor in the right direction. The surety can also help to verify the funding sources of private contracts in order to give the contractor peace of mind that it will ultimately be paid.

Remember that the surety and contractor should always be on the same team, and it all comes down to having that meaningful and trusting relationship. Although the process of obtaining a bond and meeting these requirements can be strenuous, contractors looking for bonding should understand that it is worth it to tough it out. ■