

“CONSTRUCTION BONDING AND THE FINANCIAL IMPLICATIONS”

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Risk is an inherent part of any business. Risks and the management of those risks in the construction industry is, by definition, project management and by the nature and volatility of construction projects risks are a daily event where critical decisions must be made to minimize such. Because of the many variables involved in construction that involve large amounts of money, the exposure to risk for the general contractor and the subcontractors is probably more than any other industry. Like insurance is purchased to protect against the risks of health, injuries, and certain damages construction bonds are purchased to provide protection for non-performance, non-payment, and bid withdrawals. This paper explores the various applications of construction bonding and how financial risk management is influenced by those projects requiring bonding, those that do not, and the implications of biased selections based upon bonding capabilities of the smaller contractors. A brief analysis of the future in surety bonding is also discussed.

KEYWORDS

Construction, Surety, Bonding, Risk Management.

1.0 INTRODUCTION

Construction industry risks are on one hand similar to other industries because of the monies involved but on the other hand are more prevalent because of the many variables that influence those risks, namely, time constraints, manpower, material and equipment availabilities, execution performance, and political and social elements. Minimizing the risks and maximizing the positive outcomes are the objectives of most project management teams, however, unforeseen events and changed circumstances commonly arise, resulting in increased risks of project execution performance. And, since approximately 90% of start-up construction companies fail within the first five years, the need for performance bonding is becoming increasingly popular as a requirement in the industry. The protection provided to the owner, general contractor, and subcontractors does not always remedy issues that result from non-performance and non-payment but securing the protection does minimize the risks. And, by securing bonding capabilities does not necessarily mean the owners and general contractors are contracting the best skilled and least expensive subcontractors. This paper discusses these issues, outlines various bonding types and associated financial implications and risks, the controversy surrounding possible discrimination against those incapable of securing required bonding on both public and private contracts, and what the future possibly holds for sureties and the impact on the construction industry.

2.0 THE BASICS OF CONSTRUCTION BONDING.

According to the Associated General Contractors Association, one-half of all the construction firms in business today will be out of business six years from now. And, according to Dun and Bradstreet's Business Failure Record between 1990 and 1997 80,000 construction firms failed, accruing a total of \$21.7 billion in liabilities (Saucerman 2000). While these may appear to be staggering numbers, the fact of the matter is that they're reality, and the defaults by contractors and subcontractors not only often cause business failures and the company's livelihood and craftsman's displacement, but also puts the owner's of those projects in a position of potentially severe financial risk. Because of the above-mentioned, bonding companies came into existence so that the exposure to the liabilities and risks associated with construction could be reduced, particularly for the owners. Bonding companies that provide a fee-based service for protection is referred to as a surety. If bonding companies didn't exist, the lost revenue stated would be borne by the owners in the private sectors and by the taxpayers in the public sector. Bonding and lien laws vary from state to state and can become very complex, so this section will discuss only the basic concepts of construction bonding to meet the intention of the paper.



Typically, three types of bonds are utilized in the industry; the performance bond, the payment bond, and the bid bond. The performance bond simply provides an avenue of direction for the owner should the contractor default on the contract. In the event of default, the surety company can coach the contractor into completing the work, can find outside resources to complete the work and back-charge the contractor in hopes of recovery, provide the owner the option of completing the work with other resources and back-charge the contractor, or pay the claim to the owner. But in reality, these remedies are often averted because surety companies typically are very keen in analyzing and managing the risks of the industry and their own risks drives them to pre-qualify contractors and develop relationships with the contractors to ensure successful completion. However, when a default does occur it is likely a result of bankruptcy or some other form of insolvency so the surety company steps in and attempts to protect the contractor's financial stability.

The payment bond is simply a type of security for the owner that in the event of default of the contract by the general contractor, all of the workers, subcontractors, sub-



subcontractors, and all suppliers will be paid and thus preventing any of these from possibly placing liens on the owner, even in the event that a contingent pay clause exists which states the general contractor is not obligated to pay subs and suppliers until payment is received from the owner. Payment bonds, including exoneratory and lien transfer bonds, are designed to pay the lienors in the event of non-payment. Instead of jeopardizing the owner's real property the surety company pays the claim and then seeks reimbursement from the general contractor, also known as indemnification. The payment bond guarantees that the contractor will pay workers, subcontractors, and suppliers. Usually, the owner pays the cost of purchasing a contractor's payment bond as to avoid the burden of policing notices to owners, releases, payments to subcontractors, sub-subcontractors, and material suppliers, and alleviate worries of property liens (Leiby 1997).

The third type of bond, the bid bond, provides financial security to the owner by ensuring that the bid submitted for the project by the contractor is submitted in good faith and that the contractor is submitting the bid with the intention of entering a contract for the amount of the bid price at the time of bid submission. The bid bond also provides assurance to the owner that the contractor will provide performance and payment bonds within a reasonable or predetermined time should those type bonds be required. In the event that the contractor should fail to enter into a contract or provide other required bonding, the surety of the bid bond may be required to pay to the owner damages in the amount of the difference of the bid price submitted and the next bid price accepted by the owner. Additionally, the bid bond provides coverage should a bid withdrawal occur. In this case, a penal sum of up to 5% of the bid price is imposed and payment made by the surety company. Again, the surety company's intense and rigorous contractor pre-qualification process helps facilitate and provide assurance to the owners, architects, and lenders that the contractor being bonded is capable of transforming a plan into a product with minimal financial risks involved.

Without detailing the risks borne by the owners of construction projects, it should be noted that since the contractor ultimately controls the owner's money during the project and some of the foreseen and unforeseen risks the contractor is exposed to should be mentioned so that a better understanding of why bonding requirements exist. These include:

- Inaccurate estimates and schedules.
- Timely completion.
- Subcontractor and supplier failure.
- Availability and costs of labor, material, and equipment.
- Construction mistakes and rework.
- Safety non-compliance.
- Political, regulatory, and economic changes.
- Adverse weather conditions and acts of God.

As one can see and as mentioned earlier, construction is a risky business. Risks and uncertainties are inherent to the construction industry and can be in the form of monetary loss, property damage, personal injury or a combination of these. Risks can be analyzed and controlled to a certain degree and measures can be implemented to minimize the risks but an uncertainty of activity outcomes from the beginning and towards the end of a project will always exist. Therefore, construction bonding can often be as critical an element of the contract as compared to, say, the estimate or schedule. Also, once a picture is painted of the benefits of bonding, then the reasons for bond requirement becomes clear. These benefits include, but are not limited to:

- Assuring that a qualified contractor is executing the project.
- Facilitates a smooth transition from the construction phase to the permanent owner financing by eliminating liens against any private property (government/public work cannot be liened).
- Provides relief to the private owner against liens that may be placed for non-payment to subs, laborers, and suppliers.
- Guarantees that the subs, laborers, and suppliers will be paid.
- Unqualified and irresponsible contractors are eliminated through a screening process.
- Assures that the project will be completed.
- Provides an alternative avenue for the owner to express complaints and grievances to regarding the contractor's performance.
- Potentially lowers the cost of construction by facilitating competitive bidding.

3.0 BONDING CAPABILITY AND OBTAINING BONDS.

Unlike monthly or quarterly insurance premiums, performance bonds are a one-time non-refundable premium and typically cost within a range of 0.5-2.5% of the bid amount, depending upon the type and size of the project and the bonding capabilities of the contractor. Also, it is common that no charge is applied for the bid bond and payment bond when these bonds are issued in conjunction with the purchase of a performance bond. When bonding projects, the owner specifies the bonding requirements in the contract documents and the contractor is then responsible for obtaining and submitting the bonds to the owner.



Going through the process of obtaining bonds and the determination of bonding capacities is not an easy task, especially for the start-up companies and those newer construction companies in the growth stage of the life cycle. For the purpose of this section, discussions will be focused on those smaller companies attempting bonding capacities for the first time or increasing existing capacities.

There are several preempts the contractor should consider that are important prior to initiating the process. One is the development of a relationship between the contractor and the surety underwriter, similar to that of a borrower at a bank and the loan officer, and another is sufficient preparation on the contractor's part prior to approaching the underwriting process. The latter is probably the most significant determinant of bonding capability because how well a contracting firm's owner is prepared and organized can be perceived and related back to the contractor's financial management skills and abilities to manage the company in a cost effective and successful manner. In other words, preparation can build credibility and be a positive foundation for initiating a positive relationship. With that said, the next step becomes one of understanding that surety underwriting involves a pre-qualification process and that includes a myriad of documents. The following are typical documents required, but may not be limited to:

- Fiscal financial statements for the prior three years.
- Current interim financial statements.
- Personal statements on all principals of the company.
- Bank reference letter or current line of credit.
- Completed contractor questionnaire.
- Current projects and schedules.
- Resumes of key personnel.
- Equipment schedule.
- Current certificate of insurance.
- Current corporate tax return.
- Strategic business plan.

Of course, all of the above listed documents are important and most are probably readily available, however, the documents the surety underwriter will be focus on and analyze the most are the financial statements. In preparing these documents, it should be understood that there are three types of financial statement preparations – compilation, review, and audit. Statements prepared by the compilation method are the least credible and are widely not accepted in the industry due to the risk exposure of possible manipulation of numbers on the contractor's behalf to better position themselves for acquiring bonding capability. The review method provides a greater level of assurance to the bonding agency because a third party accounting firm with an unbiased opinion has reviewed the statements for completeness, and to some degree, accuracy. The audit method is the preferred method by sureties simply because it's usually thoroughly conducted by a CPA firm and on uncompleted contracts can often identify costs in excess of billings or billings in excess of costs when using the percentage of completion billing method, in addition

to the basic financial statements of completed work (Dufek 1992). Additionally, at the core of construction financial manageability lays the importance of the firm's sound and controlled cost collection and reporting system. The point of discussion is that the better prepared the construction company is when presenting documents for bonding review, the less likely any skepticism and hesitation will arise from the lack of information or documentation, and thus increasing the probability obtaining bonds and the level of bonding capacity.

4.0 ABILITY TO OBTAIN BONDS: CONTRACTOR'S PERSPECTIVE.

Not all contractors, including subcontractors, have the ways and means of obtaining construction bonds. This may be due to a number of variables, such as past performance, credit history, lack of cash flow, and so on. However, it does not necessarily mean that the contractor who is not bondable does not have the ability to perform the work skillfully and professionally, nor does it confirm any belief that all contractors that are not bondable are irresponsible and negligent. Because a contractor cannot be bonded or chooses not to pay the premium for bonding does not necessarily mean the company is destined to fail. Granted that the Miller Act of 1935 requires all public work over \$100,000 to be protected by bonding of contractors, there are alternatives for the smaller contractor. The first is obvious; don't engage in projects over \$100,000, which of course leaves little room for growth, opportunity, and profit. So the question to the first alternative becomes one of whether or not the state and federal governments discriminate against small and minority contractors by requiring bonding for projects over the stated amount. This is an issue that deserves mentioning because challenges to the laws are currently in the courts. As an example, the city of Denver has recently won the support of the U.S. Justice Department in Denver's appeal to the U.S. District Court's ruling against Denver's efforts to remedy construction industry discrimination including the strict adherence to federal guidelines for the determination of awarding contracts according to bonding capabilities. The U.S. Justice Department filed an amicus (friend of the court) in support of Denver's appeal. The city has taken a quantum leap by establishing the Construction Assistance Program, which no longer utilizes or adheres to the federal governments use of statistical data for determination of contract awards and procurement procedures. The program provides surety bonding and working capital for small business contractors working on public projects and changes the underwriting



criteria from the federally established statistical data to that of relying more on the technical capabilities, track record, and capabilities of completing projects of the small contractor. In addition, the cities of Chicago, San Francisco, Minneapolis, Las Vegas, Phoenix, and Tucson have also filed amicus briefs supporting Denver's efforts (www.denvergov.org 2002).

The second alternative is to perform work only in the private sector where bonding is not a mandated requirement by law, unless stated in the contract. When performing work in the private sector, the decision of whether or not the project will be bonded is left strictly up to the owner, or in some cases between the general contractor and subcontractors. If a contractor has performed repeat projects over a number of years with an owner and a handshake of trust is enough assurance, then bonding may not be an issue. However, the exposure to the risk of default is still there and past business practice won't hold water in a court of law. Then there's the issue of bonding cost, as stated previously, which can be in the range of 0.5 – 2.5% of the total project bid price. This cost is usually included in the bid and passed on to the owner so, again, the decision to require bonding is at the owner's discretion as to whether or not save the money by forgoing the bond and take the risk or pay the money and have at least some level of protection.

Then the question becomes one of is it legally discriminatory to not contract in the private sector with a construction company based upon the bonding capabilities of that company. The answer is complex and not easily proven in a court of law but it may be more of a matter of focusing on the policies and practices of the surety companies rather than the decisions of project owners. Most of the bonding discrimination evidence gathered by the government agencies that are supposedly monitoring this issue is anecdotal (Beason 1998). And, many of the bonding agencies tend to place minority small contractors in a "high risk" category because of unjustified misperceptions of managerial skills that usually results in either higher premiums or raises a red flag to the project owners. So does bonding discrimination exist in the private sector? The issue has not been legally proven to exist in a court of law, however, certain state and local agencies have adopted programs, for the lack of a better term, that assists small contractors, both minority and non-minority, with establishing first time bonding capability and increasing the capacity of existing bonding.

The last alternative for the small contractor is also obvious. That is to develop trusting relationships with repeat clients and avoid the headaches of bonding altogether, and many contractors do just that. Many contractors have strategic plans for volume and profit growth while others are satisfied where they are.

5.0 THE FUTURE OF SURETY IN CONSTRUCTION.

Construction companies and owners with plans for new construction are in an age of turmoil and uncertainties, in

terms of Surety Company's financial stability, future-bonding capacities, and the forecasted premium rates to be charged for coverage. Many variables take into account for the current state. For example, in 2000 the economy went into an upswing and many subcontractors failed because they took on too much work, causing \$600 million in losses to sureties. Then a recession started in 2001 which slowed down construction and caused numerous bankruptcies. After that, the terrorist attacks in September 2001 cost an estimated \$40 billion to insurance and reinsurance giants, causing widespread panic.

Then came the collapse of Enron and bankruptcy of K-Mart, causing another \$2 billion in losses to sureties. With that said, the surety business is like many others when it comes to losses and/or not meeting projected earnings. The surety companies are very likely to "tighten the reins" on underwriting selections and re-evaluate bonding capacities for larger projects. Some construction companies may even have to put withdrawn equities back into the company to secure leverage on statements for bonding purposes. In fact, the world's largest surety company, American International Group, recently announced that it would no longer support construction firms with net worth under \$50 million. An estimated 500 construction firms worldwide have already been dropped by AIG. To make matters worse, industry experts are predicting an increase in contractor failures which means more bonding companies will have to step in to complete jobs and pay off subcontractors who would inevitably place liens.

Others don't take as pessimistic view, such as the president of the Surety Association of America, Lynn Schubert, who states "We believe the sureties will be looking more closely at each contractor in their underwriting, [but] we have not seen a significant change in the overall capacity for construction bonds" (Krizan, Korman, Tulacz, and Ichniowski 2002). The fact is that construction companies may find it harder to obtain the necessary level of bonding and those that do will let the increased premiums trickle down to the owners.

The situation is no better in the state of Florida. Opinions of many are that contractors may well face the most difficult time ever when it comes to obtaining construction bonds, simply because of the national surety situation and the fact that many reinsurers and bonding companies are getting out of the business because of the financial stress. In other words, many local sureties will be forced to write bonds without having the insurance, may not even be able to obtain it, or will be charged rates by the insurance giants that they can't afford.



So the result is that it will be tougher for contractors to get bonds and although bonding companies will continue issuing bonds they are raising their standards to reduce the risk by requiring better financial statements prepared by CPA's instead of in-house compilation. According to Bryce Guignard, vice president of Guignard of Longwood, the rising standards in Florida will mean that contractors will have to provide much more detail to the bonding companies and also should seek professional help in doing so. Additionally, many of the bonding companies are requiring that general contractors bond their major subcontractors (Scott 2002). To sum it up, the future for contractor's bonding ability will be tougher in the state of Florida during the upcoming year. This means that smaller contractors who either can't get the coverage or chooses not to can, in the meantime, either joint venture with one that has the bond capacity or perform work without the coverage.

5.0 CONCLUSION

Surety bonds and pre-qualifying a contractor for surety bonds provides the owner with the assurance that his or her project is going to be well managed and that the contractor's obligations will be met. The owner also needs the assurance that in the event that the contractor defaults on the contract the project will still be completed and everyone paid for work performed. Performance, payment, and bid bonds provide that assurance.

Bonding companies are unique in that special relationships are developed with contractors through common grounds of interest. Their knowledge of the construction industry and knowledge of the risks and financial implications are invaluable to the contractor and to the owner. They are interested not only in successful execution of projects but also in the well being and growth of the construction company. While the process of obtaining surety may be cumbersome and time consuming, it is often required and can make the difference in whether or not a contractor is awarded contracts. It is also a leading indicator of a company's ability to develop a positive reputation and grow both financially and in the community.

While bonding capability is not the sole basis of success it is an element of sound financial management, not to say that if a company cannot be bonded they're not successful. It simply means that a bonded contractor has more opportunity for exposure to a wider spectrum of projects. And, while bonding requirements may be discriminatory or may not be discriminatory will have to be left to any challengers in a court of law. Progress appears to be occurring in that direction, not so much in terms of changes in legislation but changes in how the government and private institutions are providing aid and assistance to those desiring bonding capacity that otherwise are unable to obtain.

The future of the surety business at the national and local levels and the impact on contractors, both large and small, is volatile and not easily predicted. As well known, it all revolves around the nation's economy. What can be said is that with the

recent events mentioned, the current state is causing financial hardships on many bonding companies, reinsurers, and construction companies, not to mention the owners who often ultimately pay the price. Many owners are even delaying planned projects because of the economic situation and, on the other hand, many owners are proceeding as planned. The hardest hit appears to be the very large corporations and the smaller local companies for reasons mentioned.

Recent predictions, April 15, 2002, put the recovery of the construction industry at the first quarter of 2003 as compared to predictions just prior to September 11, 2001, meaning, in the first quarter of 2003 the construction industry will be at the same level had the terror attacks not occurred. In the meantime, contractors will more often be required to produce optimal quality financial statements and cost management and control procedures as the surety and bonding companies "tighten their belts".

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