Contract Surety Bonding

Presented by: Darren Miller

Darren Miller Bio

- Darren Miller, Western HBSC 2009

<u>Background</u>

-InfoTech Research Group
-Manager, Approved Surety Company
-Director of Sales, Approved Surety & Casualty Inc.
-RIBO Licensed
-Surety Expert

Who we are: Surety

- specialty bonding wholesaler & MGA

- dedicated to working with brokers across Canada

- service driven company

- all classes of contract surety & commercial bonding through all industry segments and trades

-everything from small/new sub-contractors to large general contractors

-POA's with most major surety companies in Canada

- funds control program

Who we are: Casualty

- We are Lloyds OMC
- Tough to place
- Specialty Contractor
- Next Day quotations
- Bundling Discounts

LLOYD'S
LLOYD'S OF LONDON

Seminar Agenda

1) What is Surety/ Bonding?
2) Benefits of Suretyship
3) Types of Contract Bonds
4) What are the costs of Bonding?
5) How Contractors Qualify for Surety?
6) Perspectives from the Surety Company

What is Surety Bonding ?

What is Surety?

Surety is a Financial guarantee, it is NOT insurance

Suretyship exists whenever one party **guarantees** the performance of an obligation by another party

Example:

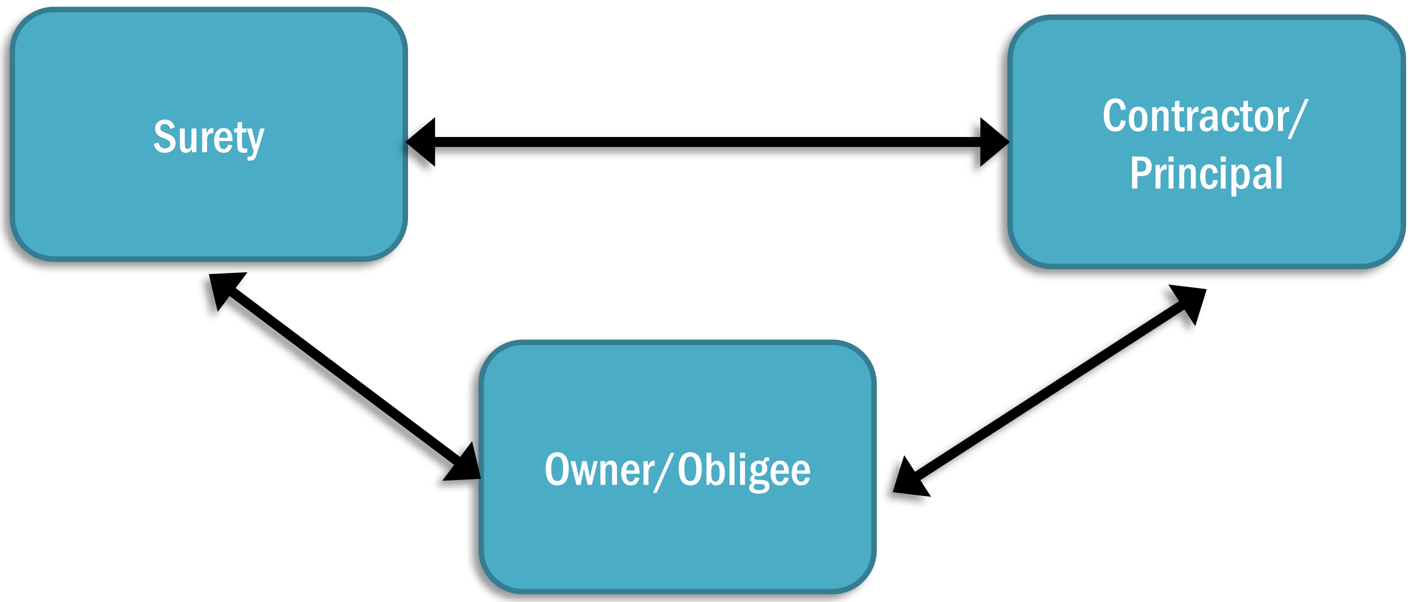
-Someone "vouches" for you.

-Your parent's co-sign a car or tuition loan**

Surety: A Three Party Relationship

Surety: the party which guarantees that the principal fulfills its obligations

Principal: the contractor; the party whose obligation is being guaranteed



Obligee: the beneficiary under the terms of a Performance Bond

What is Bonding?

- A surety bond is a guarantee that if the principal fails to fulfill its' obligations, the surety will step in and fulfill such obligations.
- A surety bond is a three party agreement between the Principal, the Surety and the Obligee.

What is Bonding? (continued)

- The **Principal**, the contractor, has the primary obligation to meet the conditions of the contract
- The **Surety**, is secondarily obligated, and then only if the Principal fails to meet the conditions of the bond.
- The **Obligee**, which is the entity mandating the bonds, receives the direct benefit of the bond, or acts as a trustee for others who receive it.

Surety Industry Overview

- 75% of premium made up of Construction Bonding

-To be discussed

  - Of the $400M, 80% of demand comes from Municipal, Provincial, and Federal Agencies
  - 20% of demand, is from the Private Sector

- 25% of premium made up of Commercial Bonding

-License Bonds

-Customs Bonds

-Estate Bonds

Example: The Global Innovation Exchange Building

$106M project – General Contractor = Bondfield

Benefits of Suretyship

To Obligee (WLU)

- Prequalification of Contractor
- Risk mitigation
- Financial Protection
- Can facilitate dispute resolution

Benefits of Suretyship

To Contractor (Bondfield)

• Reinforces credibility of Contractor among stakeholders
• Assists Contractor with:
  • Documents & Legal
  • Business Development
  • Risk Management
  • Instrument of grow (credit)
  • Emergency funding

Benefits of Suretyship

To Surety (Aviva)

- Insurance Premium $!
- **Assist in developing Canadian Infrastructure**

Benefits of Suretyship

- To Subcontractors
- To Suppliers
- To the Bank

Types of Contract Bonds

Types of Contract Bonds

Different types of bonds to guarantee different types of obligations

Tender Stage

I) Bid Bond

II) Agreement to Bond (or "Surety's Consent")

Contract Awarded

III) Performance Bond

IV) Labour and Material Payment Bond

I) Bid Bond

- Guarantees that the contractor submitting a bid, if awarded the job, will enter into a formal contract with the owner.

- If the contractor refuses to enter into a contract, the Surety will compensate the Obligee through the lesser of:
  – a fixed percentage of the contract price (usually 5% or 10%)
  – difference between the winning bid and second bid.

I) Bid Bond

The Bid Bond serves as a Prequalification Instrument to the oblige or contract owner

The Bid Bond is submitted with a Principal's tender submission prior to the tender date.

II) Agreement to Bond

It commits the Surety to providing the Final Bonds required for the contract, if the Principal is successful in their tender.

Also known as the "Surety's Consent"

Often accompanied by the Bid Bond (no premium charged)

It is also submitted with Principal's tender.

III) Performance Bond

Guarantees that the obligee will be indemnified for any loss resulting from the principal's failure to perform the work according to the **contract**, plans, and specification at the agreed price within the time allowed.

The bond "attaches" to the contract and remains in effect after changes such as an escalation in contract price or a longer duration.

Usually issued in with a **penalty** amount of 100% or 50% of the contract price. The Surety is only liable up to the bond penalty.

IV) Labour & Material Payment Bond

Guarantees that subcontractors and suppliers who have provided labour/material/equipment for the project and have a **direct contract** with the Principal will be paid.

Reduces likeliness of a subcontractor filing a lien on the project

Protection does not extend to subs of subs unless a “Broad Form” wording is used (Gov. of Canada). In such cases a surcharge applies.

- Only issued in conjunction with a Performance Bond
  - Performance bond does not grant access to contract funds in the event of default

If the Principal Defaults

If the principal is declared in default, the Surety can:

1) Remedy the default
2) Complete the contract in accordance with its terms
3) Receive bids and arrange for a replacement contractor to finish the contract
4) Pay the penal sum

Cost of Bonding

The cost of the bond is based on

1) Total Cost of Job
2) Type of Bond
3) Duration of project

Example:

Contract Price of $1,000,000

Standard Pricing $10 per $1000

Gross Premium: $10,000

=1%-2% of Total Cost of Job

Contract Surety Underwriting
How do Contractors Qualify?

The Underwriting Process

- Contract Surety underwriting more closely resembles banking than insurance
- Underwriting is **credit** based – principal is qualified on three main criteria…
- Great importance placed on establishing a relationship with the principal – **sureties like to meet clients**

The Three C’s of Credit

Capital

Character

Capacity

Plus the 2 Cs of Surety

Capital

- Financial strength of an organization
- Measured by net worth, **working capital**, profitability, reliance on bank credit, and capital structure (debt to equity ratio)
- History of profitability – profits keep pace with growth of sales
- Profit retention is necessary to achieve financial strength
- Financial Reporting is Key (financial positions can change quickly)
- Each surety has different internal benchmarks

Character

- Integrity / Honesty
- History of Claims ?
- Co-operative / Reliable
- Extent of relationship – reliance of contractor to: adequately bid job, inform the surety of unusual job hazards or onerous specifications/ contract, get surety involved immediately if a job is going in the wrong direction

- Beyond the numbers, **character** goes a long way…

Capacity

- Ability to perform the work / **technical expertise**
- Experience in scope, size and geographical area of the project
- Staff and Resources – quality of workers / retention and ability to produce in-house financials
- Equipment
- Current backlog (work-on-hand)

Communication

- On active accounts there is a natural and continuous flow of interaction – due to frequency of bond requests and interim **reporting requirements**
- Appraise us of problems on jobs in early stages
- Open and full disclosure promotes confidence in the contractor and permits the surety to stretch its support when needed.

Contract

- **CCDC**, Federal Gov't and SAC bond forms – OK
- All else – send forms (tender and finals) at tender stage for approval – wordings are weighted against the contractor and surety
- Onerous requirements in specs/contract – responsibility for extended warranties, etc.
- Surcharge owner's bond forms (typically 20%)
- **Surety must review bond forms and in rare cases, onerous contract terms before tender bonds are issued.**

Surety Support – Security

- **Indemnity and Security Agreement** is always put in place
- Sets the basis for the legal relationship between the surety and its principal
- One or more principals and/or indemnitors + spouses
- Personal indemnities: to align principal's interests with those of the surety
- **General Security Agreement**: Surety becomes a secured creditor
- **Subordination Agreement**: lender agrees to keep money in the company
- **Terms & Condition Letter,** restrictive covenants, financial ratios minimum thresholds

Surety Support- Security

- Sureties leverage support primarily from **working capital**
- Working capital = Short term assets minus Short Term liabilities
- Represents the liquidity "cushion" available to the company
- Working capital must be substantiated
  - Receivables listings and holdbacks
  - Work on hand schedules
  - Marketable Securities investment schedules

Surety Support

- Accounts are lined using a single and an aggregate limit
- Ex: $3,000,000 single case and $7,000,000 aggregate
- The Aggregate limit is measured by the remaining **costs to complete** on bonded <u>and</u> unbonded projects, plus any outstanding tenders
- Limits serve as guidelines but are not set in stone

Underwriter's Perspective on New Applicants

Underwriting Information Required

- Contractors Questionnaire
- Resumes of Owners and Key Personnel
- Corporate Organizational Chart
- Personal Financial Statements
- 3 Years of Financial Statements for Organization
- Interim Financial Statements
- Work-on-hand Report
- Aged Listings of Receivables & Payables
- Bank Reference Letter or Line of Credit Terms and Conditions
- Business Plan or List of Past Jobs

What Does an Attractive Submission Look Like?

- Track record of profitability
- Financial Strength
- Experienced principals
- Conservative business plan
- Keeps organizational structure clean and simple
- Owners keep money within firm
- Premium generation potential exists

What Does an Attractive Submission Look Like?

- Client is willing to build his relationship with Surety
  - Regular meetings
  - Open and honest communication
  - Transparent with his current work and ambitions
  - Meets commitments

Why Contractors Are Typically Declined

- Inadequate financial strength, losses, large cash outflows from business
- Job too large relative to previous work
- New type of work (plumber pursuing work in sewage treatment plant)
- New geographical area or jurisdiction (lack of knowledge of local laws, access to suppliers and sub trades, transportation/retention of staff)
- History of claims, pending lawsuits, character issues
- Poor references on jobs
- Nature of work – co-generation plants, efficiency guarantees, unique products/software, hazardous materials.
- Restricted Classes – environmental
- Onerous tender covenants – cost savings guarantees, long term maintenance guarantees
- Contractor's insurance broker does not understand surety/finance

Movie

https://www.youtube.com/watch?v=w_R-a1-kktY

Movie, Steve Ness, President of the Surety Association of Canada – http://www.suretycanada.com

Questions?

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