Clearing the Air on Bonds

Despite Their Importance, Construction Bonds Are Still Somewhat of a Mystery to Most Contractors.

By Thomas F. McCrea, CPCU

Despite its critical importance to the well being of their company many contractors have nothing more than a superficial knowledge of contract bonding.

We're going to try to clear up some of the mysteries of bonding by reducing the subject to four basic questions and then tackling these questions one at a time.

The four questions are going to be as follows:

1. What is construction contract bond?
2. What are some of the things that bonding companies are looking for? In other words how can you, as a contractor, present your most favorable image to a prospective bonding company?
3. Why is bonding so hard to obtain?
4. Who can help you obtain bonds?

Let's get right to the first question—what is a construction contract bond?

As opposed to most property and casualty insurance policies, some of which are 25 to 30 pages thick, a contract bond is a very simple instrument. It is actually nothing more than an agreement by the bonding company with the contractor, and the owner or general contractor requesting the bond, in which the bonding company assumes whatever obligations the contractor assumes under the contract.

In his application for the bond,
the contractor agrees to reimburse the bonding company for any loss or expense the bonding company may incur by reason of his failure to perform the contract.

Bonding, Insurance
Not Same Thing

It is extremely important to remember that bonding is not insurance. Bond premiums, which surprisingly have increased only slightly since 1935, do not contemplate the payment of losses.

The premium paid for the bond, which incidentally, runs less than 1% of the contract price, is actually a fee for the credit provided by the bonding company.

When the bonding company guarantees performance of a contract and the contractor defaults, the bonding company must pay. Collateral tendered by the contractor may offset some of the loss, but the collateral is not always adequate.

Unlike property and casualty insurance policies, a contract bond may not be cancelled once it is issued. The bonding company is on the hook for the duration of the job, just as you the contractor are on the hook for the duration of the job.

How about bid bonds? The function of a bid bond is to guarantee the good faith of the bidder i.e. if the bidder is awarded the contract, he will enter into the contract and furnish the prescribed performance bond.

If the successful bidder reneges, or if, agreeing to enter into the contract, he is unable to furnish the required bond, the owner normally awards the contract to the next qualified bidder.

In that case the contractor, or secondarily the bonding company furnishing the bid bond will be held liable for the difference between the original low bid and the bid of the contractor to whom the work is eventually awarded.

A certified check or bank draft can sometimes be used in lieu of a bid bond, but most contractors as a matter of convenience prefer to use their credit in the form of a bid bond rather than a certified check or cash.

Now, on to the second question, what are bonding companies usually looking for? An old axiom is that bond underwriters look for the three C’s; character, capacity, and capital.

The first two, character and capacity, go somewhat hand-in-hand. The bond underwriter wants to know if the contractor’s record indicates that he is of good character and has a decent reputation. The bond underwriter wants to know if you have the skill, experience, and knowledge to perform the kind of work you might undertake.

As regards capital, the bond underwriter wants to know if your financial condition warrants the approval of your firm as a desirable risk.

Bonding companies today usually require financial statements going back at least five years. Such statements give the bond underwriter important information beyond that of just your bottom line profit and loss.

The contractor’s financial statement may reveal an abrupt, large jump in volume or that he is working on too low a gross profit margin. The net profit margin may show that his overhead is getting out of line.

Finances Remain
Critical Items

The financial statement, or perhaps a credit report, may reveal that the contractor has problems paying his bills on time. Prompt collection of accounts receivables is the surest way of resolving any accounts payable problems.

Sometimes a financial statement can be made to appear much more attractive through the procurement of a long-term loan for the purpose of increasing working capital.

A contractor has to take a very hard look at his requirements for working capital. Without adequate working capital, he is not only going to have problems obtaining a bond, but he may very likely encounter serious problems in managing any kind of a decent workload.

Now, on to the question of why bonding is so hard to obtain. Bonding is hard to obtain because bonding companies have been and are continuing to sustain losses as contractors continue to go bankrupt.

What are some of the reasons for the failures of these contractors?

A primary reason is simple financial overextension. The contractor takes on more work, larger contracts, or a greater number of contracts than he can safely handle at one time. Any delays in construction result in financial trouble, and this is aggravated by the fact that funds become tied up on account receivables and retainages.

A second reason is lack of proper accounting and controls. Many contractors simply do not maintain accurate cost records with which to analyze contracts in progress. Without proper analytical methods, these contractors get into serious problems, and before they get a chance to really do something about it, it’s too late.

A third reason for failures among contractors would be inadequate profit margins. I think we are all aware of the dangers of bidding a job merely to cover overhead. Beyond this, even when gross margins are satisfactory, some contractors allow their overhead to get completely out of line.

Bond Companies
Want Management

Another problem with contractors is the lack, in some instances, of managerial know-how. Many contractors are former foreman or superintendents who know construction, but are weak in the principles of running a business.

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Another reason for contractor failures is neglect to provide against the unexpected. Many contractors are one-man firms who get into trouble because they do not delegate responsibility and try to run the whole show single-handed. When sickness or death occurs to the principal, there is no one to take over.

Many contractors encounter severe financial problems because they neglect when bidding new work to ascertain where the money is coming from and how it will be paid. A contractor is hard pressed for work and closes his eyes to a situation which perhaps he should have walked away from at the very beginning.

Finally, we come to the fourth question, and that is, who can help the contractor obtain bonds? Of paramount importance is, of course, his broker. The contractor should seek out a broker who has a thorough knowledge of both bonding and construction. The two go hand-in-hand. The broker should be of sufficient size to provide back-up as well as leverage and rapport with a representative number of bonding companies. Depending upon the degree of difficulty involved it is sometimes necessary to go to a half-a-dozen bonding companies or more, just as it is sometimes necessary in some instances to go to five or six banks in order to obtain a loan.

Incidentally, there should be no surprises when the broker reviews a contractor’s year end financial statement. Neither may particularly like the results, but if there are going to be undesirable aspects to the statement, they should have been discussed throughout the year. In this way plans can be formulated on how operating results are going to affect bonding and what the alternatives are in dealing with the situation.

Others who can help with bonding would be an accounting firm. A sharp, construction oriented accounting firm can present a situation in the most favorable light possible.

A contractor should also have an attorney who knows construction and who can give advice and counsel concerning all of the unique and unusual legal complexities associated with the industry.

The contractor’s banking officer, of course, a key member of the team and it is essential that he, too, know all of the idiosyncrasies of construction.

In conclusion, then, bonding companies like to think that they are in effect in partnerships with a contractor. They want their contracting partner to run an efficient and profitable business.

(The author of this article, Thomas F. McCrea, is executive vice president of Evans, Conger, Broussard & McCrea and his specialty is construction property and casualty insurance and construction bonding).