

THE BOTTOM LINE

Atlantic Coverage Corp.

Esuretyland.com

EXCELLENCE IN SURETY BONDS

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Hard Market Survival

It is time to admit that the Surety Industry has entered into a Hard Market. For the past four or five months you have been hearing from your agent about how difficult it is to get the same bonding you received only a few short months ago. For most contractors (and Surety Agents) it has been a very frustrating time. The competitive nature of our business in recent years basically forced the industry to relax its standard of underwriting. Now both the primary (Surety Companies) and secondary (Reinsurance Companies) markets are facing some substantial losses and have gone back to the "Underwriting Basics". You have heard this all before, so let's get to this article's intent, how to establish the maximum surety credit in a hard market.

First, and I cannot stress this enough, contractors need to stop referring to the fact that it was not their individual firm that caused any losses so why should they suffer. While this is true for the majority of contractors out there, from a Surety business perspective you must realize that it only takes one sizable loss from one contractor for a Surety company to become unprofitable. The industry has been faced with quite a few losses of late and the hammer has fallen down hard. In order for a contractor to be prepared to deal with this type of market he must acknowledge the need to adjust to the changing market. With many contractors this has become the hardest hurdle to overcome.

Once you are ready to deal with the Hard Market you will need an experienced Surety Agent that will be able to champion your cause to the surety markets. In the past five or so years it had become so easy to obtain surety credit that agents who admittedly knew nothing about Surety could place business. Now with the hard market a contractor's best chance for maximizing his/her surety credit is to deal with a professional Surety Agent with an understanding for

financial statements and knowledge of surety underwriting methods. A knowledgeable Surety Agent can talk with underwriters on their terms and intelligently argue reasons for the surety credit being requested. If you are curious about the information your agent is asking you to provide, ask what it is for and how it benefits you.

Financial information is now going to be underwritten much more closely. Personal and corporate credit reports will be looked at more closely. It is a good idea to run a credit report on your business, at least, and see if it is correct. If any judgments, liens and lawsuits show up that have not been addressed, it would be best to address them immediately. Credit reports are one way for underwriters to determine your payment history and to some extent, they will start establishing the character of the contractor. There has also been an increase by underwriters in personally calling bank, supplier and completed contract references. In the past, such references were overlooked or it fell to the agent to call. This was due to the fierce competition and the Surety's need to react to a submission very quickly to have a chance at writing the business submitted. Today it is taking a bit longer for a response by the Surety Companies as they are adopting the older more detailed procedures of underwriting new and existing business.

Financial statement preparation. Historically sureties allow three (3) months after a contractor's fiscal year end (FYE) to have the statement prepared. They are starting to stick to this rule once again. That means if you have a December FYE, your statement should have been prepared by the end of March early April. We are now in July, if you have a December FYE and it has not been completed, you run the risk of having your bond line frozen until it is received or severely limited to small projects.

The presentation of your financial statement will also be looked at more closely. There are three types of presentations: Compilation, Review and Audit. Continues on page 3

"Famous Quotes"

"At every party there are two kinds of people--those who want to go home and those who don't. The trouble is, they are usually married to each other."

Ann Landers

"The reward for a thing well done is to have done it."

Ralph Waldo Emerson

"You miss 100 percent of the shots you never take."

Wayne Gretzky

"Just remember, once you're over the hill you begin to pick up speed."

Charles Schultz

"The computer can do more work faster than a human because it doesn't have to answer the phone."

Joey Adams

"IT'S ONLY A BID BOND"

"All our dreams can come true if we have the courage to pursue them."

Walt Disney

"You know nothing for sure... except the fact that you know nothing for sure."

John F. Kennedy

"The secret to success is to know something nobody else knows."

Aristotle Onassis

"A great pleasure in life is doing what people say you cannot do."

Walter Gagehot

"Advice is what we ask for when we already know the answer but wish we didn't."

Erica Jong

"History is the torch that is meant to illuminate the past, to guard us against the repetition of our mistakes of other days."

Claude G. Bowers

"The whole world steps aside for the man who knows where he is going."

Unknown

"Freedom is the right to be wrong, not the right to do wrong."

John G. Diefenbaker

We have heard this comment made so many times that we realized that we need to do a better job in communicating what the bid bond obligation is. While many of us have handled, signed, and submitted bid bonds before, most of us have never actually read the bond form. We encourage you to do so the next time you get a bid bond from us.

The AIA Document A310 Bid Bond, a frequently used bond form, states that the Principal [the bidder] shall pay to the Obligees [firm to whom the bid is submitted] the difference (but not to exceed the penalty of the bond) between the amount specified in the Principal's bid and such larger amount for which the Obligees may in good faith contract with another party to perform the work if the Obligees shall accept the bid of the Principal and the Principal does not enter into a Contract with the Obligees and give the required bond or bonds as may be specified in the bidding or Contract document.

As such, the bonding company issuing the bid bond must be very comfortable that they will approve the performance and labor and material bonds if their client is awarded the project. Most of the bonding companies' analysis is performed when a bid bond is requested. Barring any bid spreads, conditions not being met, or changes in financial position

between the bid and award dates, the bonding company typically approves performance bonds rather routinely when they have issued the bid bond. This makes the bid bond a powerful prequalification tool for the Obligees.

We sometimes forget that the four-page document or the electronic document that is the bid bond has significant monetary value. For example, a 10% bid bond for a 10,000,000 project has a \$1,000,000 value. If the project is awarded to that bidder and they do not sign the contracts and post the requisite bonds, the bidder can be responsible for a sum of \$1,000,000. If the bonding company pays, they will seek reimbursement from the Principal and its Indemnitors under the General Agreement of Indemnity.

Remember that the exposure is not just the difference to the second bidder's number. Even if the bid spread to the second bidder is 1%, the exposure could still be the full 10% if a 10% bid bond were submitted. The Bid bond does not obligate the Obligees to award the project to the second bidder. They only have to act in good faith. They may claim that the second bidder submitted a non-responsive bid or was otherwise determined to not be responsible.

The bottom line – It is not just a bid bond, it is a whole lot more.

CHANGE ORDERS AND BOND PREMIUMS

Does a Performance Bond cover change order work? It is a common question. While there are some instances where the surety claims that a 'cardinal change' has been made and that the surety never intended to bond such a project, the answer is usually "yes".

This article's focus is not on the legal issues of a 'cardinal change' because these issues usually arise on a problematic project that usually results in a surety bond claim situation. We will focus this article on the more routine change order work and the additional bond premiums that come due as a result.

The bottom line is that the contractor is responsible for the premium on a contract over-run on a bonded project.

For example, the AIA Document A311, a frequently used Performance Bond form, as well as all other performance bonds, contain wording such as "...which contract is by reference made a part hereof..." and "The Surety hereby waives notice of any alteration...made by the Owner". As such, if the contract

contains change orders, the bond automatically covers those change orders. If the change orders result in an increase in the Contract Price, an additional premium is due. If there is a deduct resulting in a final contract price lower than the original, a return premium is due to the client.

How is the premium calculated on an over-run? The Bonding Company calculates the Premium on Final Contract Price, then compares this number with the Premium charged on the Original / Initial Contract Price.

For example, let's assume a contractor's Bonding Company has the following rating structure:

2.5% of the Contract for the First \$100,000 in Contract Price
1.5% of the Contract for the Next \$400,000 in Contract Price
1.0% of the Contract for the Next \$2,000,000 in Contract Price

For discussion purposes, we will keep the numbers small, but the concept remains the same. We will assume that a project has a \$400,000 Original / Initial Contract Price. For whatever reason, \$200,000 in change orders

Hard Market Survival

Compilation is the most basic and unless you are looking for bonding capacity of median six figure and smaller, it is unacceptable. Most statements are of Review quality and should be using the accrual or more preferably the percentage of completion method. The percentage of completion method is the ideal method for surety underwriters. It shows how the contractor is doing on existing projects, and how the money is being collected. It also allows for accountants to prepare the most important piece of underwriting information, the Work In Process (WIP) schedule. The WIP schedule provides a snapshot to the underwriter on the current status of all projects currently in progress. A properly prepared WIP schedule will allow the underwriter to forecast future cash flow and profitability of the contractor. A very valuable piece of information for both the underwriter and the contractor. In short, the surety will consider your bond capacity in large part on the presentation and reliability of your financial statement. In the past you may have not been pressured to improve your financial statement. Now, if you do not, you are not allowing yourself to maximize your surety credit.

There is a fine line between tax planning and harming your bonding program. If you have questions regarding how your tax planning will affect your bond program, you should contact both your bond agent and

CPA. This is extremely important that you include both professionals. They will need to work together to protect and grow your company.

Remember the more comfortable the surety is with the financial information presented the more willing it would be to provide credit. Other items Surety's will be asking for are:

- Sufficient Bank lines of credit
- Insurance Certificates
- Personal Financial statements
- (preferably concurrent to Corporate FYE).
- Corporate Tax Returns (1120S first 4 pages) Especially if S-Corp.

The Hard Market is a time of adjustment. However, if you are one of those contractors who has not given any losses to the Bond Company, and have remained consistently profitable, and left profits in your company each year (to show a positive growth trend) then the Hard Market may just work to your advantage. If you provide the proper information and improve the quality of your financial statement while others do not, odds are you will be provided with greater surety credit than most of your competitors. Contractors have had to ride out hard markets before. Cycles are a part of our business. It is the choices we make during these cycles that will determine the direction we take.

CHANGE ORDERS AND BOND PREMIUMS

were approved and completed on this contract.

Using the above rates, the resulting premium is \$7,000 on the initial/original contract price of \$400,000. At a Final Contract Price of \$600,000, the total premium would have been \$9,500, resulting in an additional premium of \$2,500. To double-check this number, \$100,000 of the change order is calculated at 1.5% (\$1,500), the other \$100,000 at 1.0% (\$1,000).

The process is the same for a contract under-run, which results in a return of premium to the contractor.

Many sureties will waive the additional premium if it is less than \$100. By the same

token, they will not return premiums of less than \$100.

It is important that you factor in the additional bond premium into your change order number.

If the Project Owner has no intention of having the additional work covered under the bonded obligation, make sure that they issue an unrelated purchase order to the Contractor to do the work. This is done very frequently. However, if the Project Owner states that the Change Order is part of the existing bonded project, the extra work is automatically covered; the liability exists and the additional premium is due.

"The person who says it cannot be done should not interrupt the person doing it."

Chinese Proverb

"The only way to discover the limits of the possible is to go beyond them into the impossible."

Arthur C. Clarke

"Action may not always bring happiness; but there is no happiness without action."

Benjamin Disraeli

"It does not matter how slowly you go so long as you do not stop."

Confucius

"Normal people believe that if it ain't broke, don't fix it. Engineers believe that if it ain't broke, it doesn't have enough features yet."

Scott Adams

"Hope is a gift we give ourselves, and it remains when all else is gone."

Naomi Judd

"Retirement at sixty-five is ridiculous. When I was sixty-five I still had pimples."

George Burns

Can We Help Someone You Know With Their Bonding?

If you think we can help someone you know with their bonding needs, please call us at (516) 682-5000. These referrals fuel Atlantic Coverage Corp.'s growth and success.

Paul F. Davis Joins Atlantic Coverage Corp.

Atlantic Coverage Corp. is pleased to announce that Paul F. Davis has joined our staff as Director of Business Development. Paul will be spearheading the growth in the New Jersey and lower New York regions. Paul will be based in our Nanuet office where he will also manage the surety business for the office. Paul was most recently, the General Manager for the New York City Branch office for RLI Insurance and was instrumental in providing a strong Surety presence in the NY/NJ marketplace. Paul began his career in the surety industry in 1985 and brings extensive experience in writing and marketing. Atlantic Coverage Corp. is looking forward to the additional expertise Paul brings to our organization. Paul can be contacted at our Nanuet office at (845) 627-8287 or via e-mail at davis@esuretybond.com.

Business News

Louis J. Spina was recognized at the National Association of Surety Bond Producers Annual National Convention in Colorado for his achievements and promotion of surety bonds in 2000.

Atlantic Coverage Corp.'s website has been updated to ease navigation and to permit the on-line calculation and comparison of many commercial surety bond products. Please visit the "new and improved" site at www.esuretybond.com.

Louis J. Spina's article titled "Into The Future with Surety Bonding" was published in the May issue of the Utility & Transportation Contractor.

Atlantic Coverage Corp. would like to thank those who participated in the Little Village School Golf Outing. It was a great success. The money raised will help these children have a permanent school.

Letter from the Editorial Staff

This newsletter is designed with our readers in mind. All inquiries and ideas regarding this or future newsletters are appreciated. Please send all inquiries to me at anthony@esuretybond.com. If you know anyone who you feel would like a copy of our newsletter, please let us know so that we can include them in our mailing list. Please let us know if you would like to receive this newsletter via e-mail.

Disclosure

The Bottom Line is published quarterly by Atlantic Coverage Corp., 6800 Jericho Tpke., Suite 212E, Syosset, NY 11791. Telephone (516) 682-5000. A service for our clients, contacts and friends, it is meant to provide useful business information and practical advice and encourage its readers to keep up with all the latest developments. These articles are not intended to provide a complete discussion of the subjects presented. Because each situation is unique, we advise you to contact us before acting upon any of the following information or planning ideas contained in this newsletter. Any questions you might have about any topics mentioned in this newsletter, please contact our office.

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