

The Greatest Risk Facing Contractors

BEYOND CONTRACT BONDS

NYC DOT Permit Bonds

While there are many risks facing today's contractors, such as dwindling backlogs and insufficient cash flow, many feel that the greatest risk facing a construction firm in today's environment is the risk of subcontractor default. This article is meant for any firm that employs subcontractors.

In case we forgot, construction business failures are often only second to restaurant failures. The most catastrophic project losses are often related to the actions of a subcontractor. Therefore, managing this risk is of the utmost importance.

If you do not purchase Subcontractor Default insurance or if you do not bond your subcontractors, then you are self-insuring this risk. That is OK, as long as you realize that the risk is real. So, if you do nothing, you are bearing the risk.

It may not be your job that is the problem, and please remember that desperate people do desperate things.

Sometimes we get lulled into a false sense of security because we have worked with the subcontractor before or because they have been in business for "x" years, etc. Plus, many contractors feel that they are adequately protected because they hold back retainage and because they are, at least, 60 days ahead of the subcontractor

from a cash flow standpoint.

This, however, does not adequately address the potential financial consequences as well as the damage done to the contractor's reputation. We must consider:

- Liquidated damages and consequential damages
- Work that needs to be re-done.
- Payments that need to be made to second – tier subcontractors, suppliers, unions, etc.
- Increased costs for the remaining work.

Let's face it. You will not get the best pricing from a replacement contractor that needs to correct previously completed work on a project with time pressures due to the project falling behind schedule.

The foundation of any subcontractor default risk management process needs to be the Prequalification Stage. The internet is a great resource for finding sample prequalification forms. Of course, feel free to call our office as well. But,

Do you do work in New York City and are required to have on file with NYC Dept. of Transportation and/or Dept. of Buildings a Permit Bond to cover each location you work at?

These bonds, previously called Street Obstruction Bonds, were revised a few years ago. The new bonds pick up the obligations that were previously covered by the NYC Public Law 14 Bond and the NYC Plumber's License Bond as well as the old Street Obstruction Bonds.

The bond limits have been increased significantly from the old limits of \$5,000 for a single location and \$25,000 for multiple locations, to the following schedule:

Single location—	\$10,000
2-50 locations—	\$50,000
51-100 locations—	\$100,000
Over 100 locations —	\$250,000

As a result of the increased limits and the increased obligation under the new bonds, many sureties have changed their underwriting of these bonds from a freely issued bond to one requiring much more detailed underwriting. Depending on the limit of bond that you need, business and personal financial statements may be required. Regardless of what limits you need, corporate and personal indemnity is required.

If your company is in need of this bond, please contact one of our surety professionals to help you with obtaining this bond.

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Update on New Proposed Revenue Recognition Rules

As outlined in last quarter's Newsletter, the Financial Accounting Standards Board (FASB) has proposed new revenue recognition rules that would significantly affect contractors and users of their financial statements.

Specifically, as proposed by FASB and the International Accounting Standards Board (IASB), the new standards seek to:

1. Remove inconsistencies in existing revenue recognition standards and practices;

2. Improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets; and
3. Simplify the preparation of financial statements by reducing the number of requirements entities must refer to.

Construction Financial Management Association's (CFMA) as well as several accounting firms are running seminars and webinars to educate you, your surety and your banker on the changes and the impact it will have on

your financial reporting. It is important that you take the time to look into these changes and discuss them with your CPA and surety to make sure you are prepared to adapt to these changes once they are implemented.

We will provide updates as they become available through our newsletter and e-blasts that we will provide from time to time on the subject. You can also go to the CFMA website—www.cfma.org—or contact your CPA for updates as well. If you have any questions/concerns, feel free to contact us.

WHY ALL THE QUESTIONS? IT'S ONLY A BID BOND

We have heard this so many times that we realized that we needed 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.

For starters, if a bidder does not provide a bid bond, most specifications allow the bidder to post a certified check as bid security. For discussion purposes, let's assume that the specifications call for a 10% bid bond or certified check on a \$5,000,000 project. One could easily equate the value of the bid bond to the \$500,000 certified check that could be provided in its place. So, right there, it is more than just five pieces of paper.

The AIA Document A310 (2010 Edition) Bid Bond, a frequently used bond form, states the Contractor and Surety are bound to the Owner in the amount set forth in the bond if the Owner accepts the Contractor's bid and the Contractor either enters into a contract with the Owner and provide the required Performance and Labor-Material/Payment Bonds or pays to the Owner the difference (not to exceed the amount of the bond) between the Contractor's bid and such larger amount the Owner may in good faith contract with another party to perform the work.

As such, the bonding company is-

suing the bid bond must be very comfortable that they will approve the performance and labor and material / payment 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 Obligee.

We sometimes forget that the five-page document has significant monetary value. In the example above, the 10% bid bond for a \$5,000,000 project has a \$500,000 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 up to \$500,000. If the bonding company pays, they will seek reimbursement from the Principal and its Indemnitors (stockholders, spouses, affiliated companies, etc.) under the General Agreement of Indemnity. This makes the bid bond a very serious obligation.

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 Obligee 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.

Plus, in some bids, the owner requires that a "Consent of Surety" be provided with the bid bond. This makes it even more serious since the terms of the typical consent require the surety to issue the Performance and Payment Bonds if the project is awarded to the contractor, with no out provision.

Without this consent, bonding companies can, and sometimes do, refuse to issue Performance and Payment bonds in those cases where they issued the bid bond. There are many examples of this. The most common instances are those when the financial condition changed between the bid and award dates, a claim or potential claim arose on another bonded project, conditions set at the approval of the bid bond are not met or there was a substantial bid spread (more than 10%) between the contract and the next highest bidder.

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



LOOKING AHEAD

Contractor's for Kids Event (CFK)

- **CFK Annual Dinner Gala**—January 21, 2011 @ Crest Hollow Country Club, Woodbury, NY. Go to www.contractorsforkids.org for event information.

Women's Insurance Network of Long Island Event (WINLI)

- **WINLI's Annual Charity Auction**—March 27, 2010 @ Woodbury Country Club, Woodbury, NY - Proceeds donated to Nassau Coalition Against Domestic Violence and Special Olympics of Long Island. Contact Denese Thompson for more information.

Health Reimbursement Arrangements

There are a variety of different Health Reimbursement Arrangements that you, as an employer, can offer to your employees.

Have you ever wondered what the differences are and the benefits and disadvantages between the different programs?

Attached is a link to a very informative article prepared by Anthony Martillotti, one of the principals of Amerisc Benefits, in which he presents an detailed comparison between Health Savings Accounts, Health Reimbursement Arrangements and Flexible Spending Accounts.

Please review. We are sure you'll find it very informative. If you have any questions concerning these programs or you would like this chart mailed to you, please contact Anthony at Amerisc Benefits—516-745-7534.

http://www.atlynx.com/Comparison_of_HSAs_HRAs_and_FSAs.pdf

TEN SECRETS TO SUCCESS

Investor's Business Daily (IBD) spent years analyzing leaders and successful people. IBD determined that most of them have ten traits that, when combined, can turn dreams into reality. A couple of years ago, they published these "10 Secrets to Success", and, as we kick off a new year, we thought that we would share them with you again.

1. How you Think is Everything – Always be positive and avoid negative environments.

2. Decide Upon Your True Dreams and Goals and Develop a Plan to Reach Them

3. Take Action – Just do it.

4. Never Stop Learning – Read books, acquire skills, get training, etc.

5. Be Persistent and Work Hard – Success is a marathon. Never give up.

6. Learn to Analyze Details

7. Focus Your Time and Money

8. Don't Be Afraid to Be Different – Innovate. Following the crowd is a sure way to mediocrity.

9. Deal and Communicate with People Effectively – Learn to understand and motivate others.

10. Be Honest, Dependable and Take Responsibility for your Actions (Otherwise, the first nine secrets won't make a difference)

Best wishes for a healthy, happy and successful 2011.

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some of the basic information that needs to be developed during the process includes:

- General Information on the firm, ownership, etc.
- Capabilities, including Licenses and Geographic footprint
- Projects Completed with references
- LEED Accreditation
- Safety Information
- Union Agreements
- Key Employee Information
- Financial Information, including Bank information and Financial Statements
- Dun & Bradstreet Report, especially looking at Public Filings
- Vendor references
- Bonding Capabilities

- Insurance / Risk Management

Much of the above information will be captured on the Pre-qualification Questionnaire that the subcontractor will need to complete. Your firm will need to review the information, call the references, order the Dun & Bradstreet report, etc. Pull in your other professionals if you need their assistance with certain key areas, such as your insurance broker and your surety broker.

Then the next most important step is to listen to what the prequalification process is telling you and to not be swayed from it because of a long-standing relationship or because the subcontractor's price is just too good. Experience has proven that the lowest price is not always the least expensive when the day is done. Finally, the prequalification process is an ongoing one that needs to constantly be monitored and updated.

Firms that do this will have a strategic competitive advantage over its competitors. These times demand better risk management. Some firms will not survive this downturn. This is a fact.

W. Edwards Deming once said "It is not necessary to change as survival is not mandatory". Be one of the firms that not only survives, but is in a position to fully take advantage of the next upswing in activity.

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*The Four C's of Suretyship**The Three "C"'s of Surety Credit*

The surety will always speak about the three "C's" of surety credit which are:

Character— which can sometimes be the most difficult to underwrite. This speaks to the contractor's moral and ethical character, reputation and how he is looked at by his co-workers, employees and the community.

Capital—the financial capability of the contractor. The underwriter will do a full financial statement analysis.

Capacity—here is where the underwriter will make a determination of how much work a contractor can perform profitably.

We strongly believe that there is a fourth "C".

Cooperation (with the Surety)

Give them the information that they want, in a timely manner and in the format that they expect, and they will respond more favorably.

This may be the most important C of all.

Letter From the Editorial Staff

This newsletter is designed with our readers in mind. All inquiries or suggestions regarding this or future newsletters are appreciated. Please send all inquiries to denese@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.

Check our website www.atlynx.com for past editions of our newsletter.

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