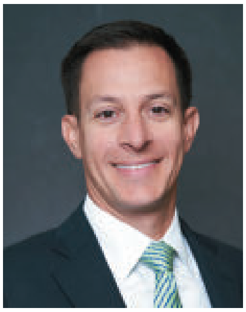
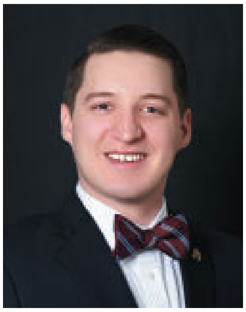
feature

Surety and Construction Attorneys' Perspective:

Surety Prequalification Goes Beyond Three Cs

Bond producers are pros when it comes to assessing the capabilities of contractors.

BY MICHAEL C. ZISA AND JOSEPH N. FROST

CONSTRUCTION IS INHERENTLY risky, and sureties are calculated risk takers. In order to calculate the risk, sureties undertake a broad, rigorous, and thorough prequalification process to determine whether and to what extent to extend credit to a contractor in the form of a bonding program. In this way, sureties and bond producers are uniquely situated to identify, mitigate, and avoid risks to the various stakeholders in the construction industry.

With more than 20 years of collective experience practicing surety and construction law, we have developed a unique perspective on the surety prequalification process. While the surety underwriting process is often summarized with reference to the "three Cs" of bonding—capital, capacity, and character—this phrase falls short of describing the true extent of the robust and complex set of processes, checks, and systems that sureties and surety bond producers have developed over the years to fully assess the potential bond principal and risk the sureties will be assuming.

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Owners, general contractors, lenders, sureties, and bond producers alike share in the goal of identifying and either weeding out or appropriately mitigating risky contractors. Doing so ultimately lowers costs, increases profits, and increases the likelihood of completing projects on time. To that end, sureties and bond producers, through decades of practice, have gained significant experience in assessing a potential bond principal. Underwriters and producers have the skill and experience to identify the issues that raise red flags and to know whether these flagged issues are worth the risk they pose.

The surety prequalification process often involves multiple layers of risk assessment. Frequently, bond producers will fully vet a contractor's prequalification package before presenting it to any surety company, often working closely with the contractor to gather new or different supporting information to ensure that the package presents a full and accurate picture of the contractor. Once the surety receives the prequalification package, the surety underwriter will then undertake his or her own thorough assessment of the contractor. Thus, the surety prequalification process provides a safety net for owners and general contractors, whereby sureties minimize the risk and allow owners and general contractors to focus on completing their projects.

Purpose of Prequalification

The surety prequalification process is intended to assess potential bond principals as wholly as possible to alleviate the inherent risks associated with the construction industry. Surety professionals have dedicated professionals who have the training and experience to know precisely what to look for. Because of this, surety professionals are in the best possible position to minimize risk not only for the surety but also the other stakeholders in the construction industry.

When a contractor defaults, the impacts cascade throughout the project, frequently causing increased costs and significant delays. Importantly, though, if a bonded contractor defaults, the surety will likely be called upon to cure the default. Although sureties generally require principals to execute indemnity agreements, any amounts for which the surety is not able to receive indemnification will be paid from the surety's own coffers. Accordingly, sureties have an especially heightened interest in implementing and maintaining a rigorous prequalification process to avoid losses in the first place.

Prequalification Process

Although the specifics of the prequalification process vary from surety to surety, there are some concepts that are utilized by many throughout the industry. The surety prequalification process seeks to gather information about all aspects of a contractor's business, including, but not limited to, financials, performance history, and contractor reputation, all of which is taken into account to thoroughly assess the contractor. It is important to remember that sureties maintain discretion on whether to issue bonding programs to contractors based upon the analysis of a contractor's prequalification application. In that way, sureties are better able to balance risk with the potential upside.

A. Financial Information

At an absolute minimum, contractors will be asked to provide details about their company's finances. Generally, underwriters and producers request to see CPA-audited financial statements for the preceding three years. In addition, contractors will be asked to provide their current financial statements, including balance sheet, accounts receivable and payable reports, cash flow statements, and so on. While it is best practice to have audited or reviewed financials available throughout the year, keeping a CPA on retainer may be cost prohibitive. So even if this is not an option, contractors should be sure to tie the current unaudited financial statements to the last audited versions for easier and more accurate comparison.

Contractors will be asked to produce a detailed report of any work in progress (WIP). Because multiple projects are covered under the same bonding program, surety professionals will continually track WIP and compile a completed contract schedule that compares projected financials to actuals, in an attempt to identify any profit fade or other trends. Similarly, underwriters and producers also keep a watchful eye for under-billings so that the contractor's balance sheet can be appropriately adjusted to reflect the realistic values. Contractors may also be asked to provide details about significant open change orders or claims to ensure they are accounted for properly.

In addition to financial statements, the surety prequalification process seeks to ensure a contractor has adequate means to stay afloat and complete its contracts. For example, sureties and producers frequently request information related to a contractor's cost control and risk management mechanisms, working capital, and the specifics of any bank or other credit relationships.

Beyond the financial information for the potential principal, the contractor may also be asked to submit information concerning related entities. Every related entity needs to be reported, as well as any intercompany receivables associated with those entities, so those relationships can be evaluated in the prequalification process.

Contractors will also often be asked to submit personal financial statements of key individuals and ownership, especially if the contractor is a small business. Underwriters and producers are not necessarily looking for high net worth individuals. The purpose is to examine how the owners handle their personal financials to gain a better understanding of how the business' financials may be affected, and underwriters are looking for any debt, mortgages, auto loans, etc. that may impact the potential indemnification. Although it may seem obvious, it is vital that individuals complete their personal financial statements accurately and honestly. Discrepancies with the personal financial statements can cause serious issues for the potential principal.

B. Performance and Reputation

Just as important as a company's financial strength is its performance history. Contractors will be asked to provide summaries of previous projects and will also need to provide detailed reports of owned and leased equipment, personnel, and workloads. Underwriters and producers will also investigate a contractor's reputation within the industry, including owners, subcontractors, suppliers, and lenders; and a contractor may be asked to explain any negative feedback or previous project issues and terminations. All these metrics are taken into account in assessing a contractor's likelihood of successfully performing in the future.

While performance history is key, a prospective performance analysis is also necessary. This analysis frequently includes a review of the contractor's organizational chart, resumés of key employees, management plan, key person insurance, and continuity planning. Underwriters will also evaluate, on a particular project, the percentage of subcontractors that are bonded back and the percentage of work that the contractor intends to self-perform.

Finally, in preparing the prequalification package, including a statement of history of the business, success stories, challenges overcome, long-time employees, references, and other unique information about the company can have a positive impact on the prequalification process.

The Benefits of the Surety Prequalification Process

Underwriters and bond producers add significant value to the construction industry through the rigorous surety prequalification process. Sureties and producers have been utilizing the prequalification process for decades and have grown to include dedicated professionals within these organizations who deal solely with contractor prequalification. These dedicated professionals contribute to a more streamlined contractor assessment process that is able to cut costs and reduce risks. Because of the long-standing experience and skill in prequalifying contractors, sureties alleviate the burden of owners and general contractors having to implement in-house contractor prequalification assessment procedures, which add costs and administrative responsibilities.

Similarly, because these dedicated professionals analyze prequalification applications on a regular basis, they know what to look for, including what issues raise red flags, how to alleviate the concerns associated with those issues, and at what point a red flag becomes significant enough to prevent the surety from issuing a bonding program to the contractor. Due to this experience, sureties and producers are better able to identify the complete picture of potential risks, request additional information from contractors, and assess the true risk levels associated with various risk factors.

On top of all of that, an experienced producer has an intimate working knowledge of the different surety companies and the types of contractors to which each surety typically extends its bonding programs. Thus, a quality producer is able to effectively synthesize a contractor's prequalification package, as well as past and upcoming projects, in order to best select a surety that would be in the market for issuing bonds to that specific type of contractor, project, or risk level.

Conclusion

Sureties and bond producers have developed a complex and robust prequalification process over decades. The experience gained has translated into a surety prequalification process that efficiently and consistently identifies risks so that these risks can be appropriately mitigated or avoided. Sureties have personnel whose only tasks are to review and process prequalification applications. Because the surety prequalification process is so thorough, it places sureties in the position to identify and mitigate undue risk.

NASBP Bond Producers' Perspectives

"Not just anybody should be able to get a performance bond, which is why the prequalification process of a contractor will allow the owner to 'Be Guaranteed to Succeed' in respect to the completion of the owner's project. As surety professionals, it is our obligation to prequalify contractors—and work in conjunction with the surety companies—to provide bonds to ONLY those contractors who meet the highest level of scrutiny."
Zach Mendelson
Principal, Bonds/Insurance/Construction
EPIC, Pittsburgh, PA

"Sureties and professional agents continually prequalify clients with internal numbers and updates. It is not a one-time prequalification; it is ongoing and very detailed!"
Lawrence F. McMahon, AFSB
Executive Vice President, Surety Manager
Construction Services Group
Alliant Insurance Services, Inc., San Diego, CA

"'Be Guaranteed to Succeed'—it is more than a slogan or tag line for the surety professional. It's our mantra and the model of how we work. Within commercial surety, we're ensuring thousands of obligees and owners that their obligations and requirements will be met every single time. The prequalification that the surety professionals provide to commerce and consumers helps to restrict the bad actors from entering into key areas of business and financial services."
Corban Enns
Area Vice President
Surety Solutions, Salem, OR

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