



# HOW TO GET BONDED

by Carl Traina

*A surety promises to stand in your shoes if a project fails. But first you've got to convince him you're a safe bet.*



Cary Twitchell

Contractors who predominantly work in residential construction have little need for surety bonds. But bonding is important for people who want to break into government work or who want to build doctors' buildings, professional offices, and other commercial/industrial projects. If a contractor is going to get into development himself – for example, by developing small retail stores – he may want to know about bonding his subs, thereby guaranteeing their contracts with him.

The federal government started bonding as we know it in the 1930s when it was pumping money into the economy by building. The government sought a way to guarantee that its projects would be built as specified. Its answer was the Miller Act in 1934, which provided for performance bonds and payment bonds.

One at a time, each state adopted some form of the Miller Act, requiring state work to have a bond. Then the states said towns and authorities could require bonds. Finally, lenders pushed bonding into the private sector when they recognized the bond as a guarantee.

A bond is a three-party agreement involving the *principal*, who is the contractor proposing to do a project; the *surety*, who stands behind the principal; and the *obligee*, the owner of the project. A bond cannot exist without a properly completed contract between the principal and the obligee because the bond guarantees whatever the contract says.

## Types of Bonds

All bonds basically guarantee the same things – performance and payment. The specific types of bonds needed depend on the job.

Statute bonds – those required by state or federal law – are pretty standard. But common-law bonds – those written for private jobs – are drawn to meet the needs of a particular job. On private jobs, I can't emphasize enough the importance of getting the terms of your contract standardized on the American Institute of Architects form. It's a time-tested, proven form that covers all the necessary points without adding unfamiliar conditions from job to job.

Different bonds guarantee different things. A *performance bond* guarantees completion of the contract and terms as specified. A *payment bond* guarantees that the contractor will pay the bills. If the contractor doesn't, the surety will.

A precursor to both the performance and payment bond is a *bid bond*. For a contractor, it guarantees two things: that you will enter into a contract if your proposal is accepted, and that you have a surety to guarantee the overall contract. If you don't enter into the contract, the surety is obligated to pay the amount of the bid bond – which is usually the difference in cost between your bid and that of the second bidder.

A general contractor wants performance and payment bonds, while a subcontractor wants subcontractor performance and payment bonds. Yet another type of bond ensures that suppliers will be paid. In this case, suppliers want material supply bonds.

These are all different tiers of the same basic guarantee.

In addition, a developer may have to obtain a subdivision bond to get municipal permits. A subdivision bond guarantees the building of a road to specifications.

### Where To Get Bonding

Sureties may be departments in large insurance companies or they may be companies that write only bonds and no other kind of insurance. They may write for several types of projects or just one. For the most part, these insurance companies and bond companies are state-regulated.

The federal government uses a system to qualify sureties. The Federal Register reports quarterly the maximum bond capacity that a surety can write on a single federal job. Called the T List, it tells you, for instance, that Aetna Life and Casualty, by far the largest surety, can write a bond for some \$600 million. It goes right down through American Resources Co., which can write a bond for \$418,000. Liberty Mutual, USF&G, Fidelity, and CIGNA are all major players.

There are also lesser sureties, some of them regional. A quick telephone call to the state insurance commissioner's office will tell you whether a surety is licensed or not in your state.

The Small Business Administration (SBA) also backs bonds, primarily for companies that are less than three years old and can't obtain standard bonding. Many standard-market sureties won't write SBA guarantees, but a few small firms specialize in them. These carry an extra fee.

### The Cost

Sureties try to minimize risk by operating as a bank does: Prove to me there's little chance that you'll fail and we'll do business. A bonding agent is really in the business of prequalifying contractors. The rates for most bonds are standardized through an organization called the Surety Association of America, although some sureties don't subscribe to the rate and assign their own (see the sidebar, "How Do You Rate For Bonding?").

Some subcontractors, such as roofers, glazers, and suppliers, are considered easier to underwrite than general contractors because less time is needed to check them out. That makes their rate generally lower. On the other hand, highway-building contracts require a lot of checking out, so the rates are higher. The highest risk factor – and rate – is for asbestos work.

The contractor builds the bond fee into the cost of his project. So, on a private job, the owner pays. On a public job, the state or municipality pays.

### Pre-Qualification

The amount of information that the surety will want is initially tremendous. And at that point, ask yourself, "Am I sure I really want to do this?" There's a financial burden to generating the type and quality of information necessary. If you're a general contractor and you want to make a living being the lowest bidder on public contracts, you have to do it. But if you do mostly private-sector work and just 10% of your jobs require bonding, maybe you want to eliminate that 10% of your business. (Being your own developer for commercial projects may require just as much financial information.)

The first thing a surety asks is, who's your accountant? He's got to be a CPA, and he's got to use the "percentage-of-completion" method of accounting. It's the only form of accounting that makes sense for a builder, and not all CPAs can do it. Find a CPA who has other contractors as clients and knows bonding requirements.

Don't hand your surety an inadequate financial statement and say, "Don't worry. I didn't show it all." And don't say, "We don't do financial statements." If someone has no use for his own financial statement, he has no use for a bonding agent.

Similarly, if you're not incorporated or don't have some form of a business entity other than a sole proprietorship, don't bother trying to get a bond. A surety will find a polite way of saying, "Hey, that's nice, but you're not sharp enough to do business with." Continuity is also very important when you're trying to get a bond. If something happens to the principal, the surety would like to think that the company will continue to function. It wants a well-structured buy-sell agreement, even in a subchapter-S corporation. In some cases, life insurance is purchased for the key individual. If he dies, a couple of hundred thousand dollars comes into the corporation to hire someone to manage things.

When you prepare to shop for a surety, minimally, your last three fiscal-year financial statements will be required, and they should be CPA-audited. (The surety likes the conservative viewpoint of the CPA, who tries to make the client look the worst he can to reduce taxes.) If you had two losing years out of the last three, forget it. Sometimes the surety will go back over five years. The trend's got to be positive. Sureties also will require an interim financial statement of six months to indicate current trends.

The business plan is important, too. It reveals if a contractor knows where

his business is going. Someone with no business plan is not a good risk.

A builder will have to demonstrate that he has a relationship with a bank. Part of that relationship, ideally, is an unsecured line of credit or a line of credit secured by a personal guarantee. The assignment of the assets of the contractor to a bank is not acceptable: Such a contractor will not be able to get bonding.

The surety is also going to look at the character of the organization, its capacity to do work, experience with large contracts, the background of the administration, and how much work the firm can do.

### What Is Bondable?

The developer cannot supply a bond to the bank because the only thing a surety can bond is a contractor. If the contractor is the developer, he can't have a bond because a surety can't guarantee the contractor's own performance to himself. In that case, the developer/general contractor may have to bond all the subs. But don't add the bank to the bond, because the bank has no contractual relationship with the subs, only with the general contractor. Sometimes to get a bond, a general contractor who is acting as developer may have to hire another builder to be his general contractor. That hired contractor can then get a bond.

In private projects, a lien bond may be available. This removes any lien placed on the building. But a lien bond must be recorded with the register of deeds to be valid. If it only sits in a drawer – and it often does – it's worthless.

### Subdivision Bonds

Typically, sureties don't want to write a subdivision bond, which is nothing more than an agreement or covenant to complete a road in compliance with town code. Basically, a developer can

provide one of four guarantees: He can give the cash or a certified check; he can give a bond called a subdivision bond or a road bond; he can accept restrictive covenants filed by the zoning board; or he can enter into a tri-party agreement. That tri-party agreement really is just a letter-of-credit from the bank financing the project that says it will pay for the roads if the developer fails to. Usually only the smallest sureties will write subdivision bonds, and so will professional associations for their members.

It used to be that no one charged for letters of credit, but now banks do. In fact, the bonds are now cheaper than the letters of credit. Some sureties will sell you the subdivision bond if you produce a 25% letter of credit. But collateral is really the only inducement a surety has to write a subdivision or road bond.

### Downside of Default

The surety sword is double-edged: On one side is the benefit of the guarantee a surety offers, on the other is the surety's right to liquidate the organization that caused it the loss. If a surety has to attach the principal's personal assets, it will do so. If there's nothing left over, it's coming out of the surety's pocket at that point, and generally, that's what happens.

The second outcome of default is that the chance of the individual or organization that defaulted of getting another bond is extremely remote.

There's one more serious downside of default. Once a surety is called into a distressed project, you can expect to complete it at least two years late. For starters, it's going to take six months for the surety to evaluate the project. Sureties aren't really good at managing construction; they must hire people to do it for them.

When a project goes sour, you often have an undercapitalized contractor, an architect who's out to prove the building is designed correctly, and an owner who all of a sudden has no money. The bank finally calls the surety and says, "Solve our problem." The first thing the surety does is send an attorney to just talk and find out what to do. There are two approaches: active or passive. An active surety makes a lot more sense. Why? Because the project gets done. They don't delay. If someone has a contract with you and you think he's going south, look at the contract's notification provisions. If the contractor can't do the job, or he won't do the job, or he's not qualified, get rid of him. Otherwise tell him: "You fix this in seven days or you're gone." That's what the surety likes. You call the surety and send a copy of your demand letter. If the guy defaults, then the surety can do something. If you're the bonded contractor and are not getting the job done, this is what your developer should do to you.

One thing is certain: Either there has to be default or the bonded contractor has to come to the surety and say, "Hey, take me over. Let's get going with joint control. I don't want to lose the profit, and you can help." Don't delay, that's the key. When the surety says it will investigate, set up a meeting – a date and time. The surety will respond. It has no reason not to. It's in the surety's interest, too, to get the job done. ■

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## How Do You Rate For Bonding?

Bonding rates remain competitive, but many writers of surety bonds use as a guide the figures recommended by the Surety Association of America in Vineland, N.J. Dennis Wine, vice president-surety, says, "Nobody follows them verbatim."

The advisory rates give you an idea of how costs change, depending on the size of your project, the type of work you do, and the risk that stems from your firm's financial condition. It comes down to this: The bigger the project, the simpler the work, and the stronger your company, the lower the cost per \$1,000 of contract value.

**Size of project.** Rates drop in increments, depending on the size of the project. The increments are the first \$100,000, the next \$400,000, the next \$2 million, the next \$2.5 million, an additional \$2.5 million, and over \$7.5 million. So, a project for less than \$100,000 would carry one rate per \$1,000 contract value, while a project for \$7.5 million would carry six different rates.

**Class of work.** The rates for each increment vary by type of work. Class B, which includes most general construction such as building, carpentry, electrical, hvac systems, plumbing, and mechanical, carries the following incremental charges per \$1,000 contract value: \$25 on

the first \$100,000, \$15 on the next \$400,000, \$10 for the next \$2 million, \$7.50 on the next \$2.5 million, \$7 on the next \$2.5 million and \$6.50 over \$7.5 million. Class A, which includes less complicated work such as glazing, roofing, and mill work, carries incremental charges of \$15, \$10, \$7, \$5.50, \$5, and \$4.50. Class A-1, for even simpler jobs such as guard rails, sidewalks, flag poles, and gas tank installations, carries incremental charges of \$9.40, \$7.20, \$6, \$5, \$4.50, and \$4.

**Financial condition.** Rates for all types of projects and all classes will average 1% to 5% of the value of the contract. The bigger companies with proven track records will earn the lower figure, which reflects the standard advisory rate. First-timers and smaller companies will have to pay the higher figures. "A contractor looks for bonding the way a consumer would go to an independent insurance agent," Wine says. "Maybe he'll be told, 'The only way I can bond you is to go to this surety company, which charges 4%.'" As you gain experience and prove your ability to perform, the bonding agent will find you lower rates.

— Gary Mayk