The discussion of bonds is an interesting one because the process of achieving bond-ability is really a study of the inner workings and health of a contractor. With new developments in project insurance today, this requires a rethinking of existing practices.

A simple definition of both bonds and insurance should clear up some misconceptions.

- **Bonds** These provide *guarantees* of project performance and completion to a third party, typically an owner.

- **Insurance** A *loss-sharing mechanism* that guards the policy holder from damages that may be incurred in the future.

### This Risky Business

Everyone in the industry recognizes the inherent risks in the construction business—it is an open-air manufacturing facility producing a one-off product; subject not only to the vagaries of the weather, but potential labor shortages, disputes, and material shortages. Contracts containing a fixed price for some projects may extend two years or more, while razor-thin projects can be wiped out faster that you can say “Help!”

A recent study conducted by Ken Roper and Michael McLin of FMI Corporation supports the tenuous nature of the contracting business:

- Dun & Bradstreet reported that more than 10,000 contractors fail annually.
- The surety industry has lost $3.4 billion between 1998 and 2003.
Most company failures are due to poor operational execution.

Many general contractors are just one difficult project away from bankruptcy.

The nearly 30-percent business failure rate among general contractors and subcontractors leaves a residual of unfinished projects and losses to their owners in the billions. That’s why more and more owners are requiring contractors to provide bonds—primarily payment and performance bonds—for their new projects. The federal government has required contractors to be bonded since 1893. In 1935, the Miller Act forced contractors to provide payment and performance bonds on all public works contracts valued at more than $100,000, and payment bonds for all contracts exceeding $25,000. All 50 states, plus the District of Columbia and Puerto Rico, have enacted similar laws requiring bonds.

Why Contractors Fail

A 2005 report issued by the Surety Association of America (SAA), which was prepared after their review of 86 claims, identified the five top factors contributing to contractor failure.

1. Unrealistic growth or change in the scope of business—37 percent of cases reviewed
   - Change in the type of work performed
   - Change in the location of work performed
   - Significant increase in the size of individual projects
   - Rapid expansion

2. Performance issues—36 percent of cases reviewed
   - Inexperience with new type of work
   - Personnel do not have adequate training or experience
   - Insufficient personnel

3. Character/management/personal issues—29 percent of cases reviewed
   - Contractor retires, company is sold, changes in leadership or focus
   - No ownership or management transition plan exists to ensure continuity of operations in the event of a principle’s death or disability
   - Key staff leaves the company
   - Staff inadequately trained on company policy and operations

4. Accounting issues/financial management problems—29 percent of cases reviewed
   - Inadequate cost and project management systems
   - Estimating and procurement problems
   - Lack of adequate insurance
   - Improper accounting practices [not adhering to the Audit Guide for Construction Contractors (AICPA)]
5. Other factors (which also seem to point to management problems)

- Economic downturn and/or high inflation
- Weather delays
- Poor site conditions and/or building plans
- Labor difficulties (lack of skilled labor)
- Material and equipment shortages
- Owner’s inability to pay
- Onerous contract terms

The SAA developed a profile of the qualities associated with a solid contractor organization. They include

- Formal and on-the-job training for all levels of employees
- Logical, incentive-based compensation programs
- Tenure for proven field supervisors, and internal promotion wherever possible
- Depth at all levels of the organization
- Succession planning
- An up-to-date, distributed organization chart
- A culture of loyalty, ownership, and urgency
- Visionary, inspirational leadership
- Low turnover

Finance:

- Solid management of cash flow and overhead
- Profit-focused company
- Timely payment of bills
- Management of debt and retainage
- Reasonable growth without over extending resources

Marketing:

- Superior estimating skills and systems to manage costs
- Satisfied customers
- A well-defined market niche and a 12–36 month growth plan
- A company culture where everyone is a great salesperson

Project Control:

- Closely managed projects with early warning systems to catch potential problems
Litigation avoidance
Productive field managers trained to improve processes

Planning:

Disaster preparedness
A continuity plan with adequate life insurance
A shareholders agreement detailing buy-sell understanding for multiple shareholders
Only qualified and interested family members in management
A detailed business plan
Strengths, weaknesses, opportunities, and threats

Where does your company fit in this profile?

Bonds and the Bonding Process

Bonds are, in effect, a three-party arrangement between a surety (bonding company), a principal (contractor), and an oblige (owner). The most frequently employed bond forms are the payment and performance bond and the bid bond. With respect to a payment bond and performance bond, the surety obligates itself to pay the oblige if the principal does not meet the performance criteria (of a performance bond) or payment requirements (of a payment bond) of the bond.

The bid bond provides financial assurance that a contractor intends to enter into a contract with the owner at the price in their submitted bid. If the contractor fails to accept the offer of an award, they forfeit the value of the bond and the owner is free to use those proceeds toward the contract sum of the next lowest bidder.

The terminology of bonds

The following terms are related to bonds:

Calling the bond. Notification to the bonding company by the owner (oblige) that the contractor (principal) has failed to live up to the terms of the contract for construction, and that the owner requests that the bonding company (surety) provide sufficient funds to cover the contractor’s unsatisfied contract commitments.

Consent of surety. On the successful completion of the construction project, when all bills have been paid and all provisions of the contract fulfilled, the terms and conditions of the payment and performance
bond will be considered to have been met. The contractor will then request surety to “sign-off” on the bond, getting consent of the surety that the bond requirements have been fulfilled, before releasing the bond.

**Dual obligee.** When two parties have a financial interest in the project, such as an owner and the lending institution that provided the funds, the bonding company will have a financial obligation to both parties—a dual obligation—if the contractor fails.

**Guarantor.** The underwriter or surety company, as opposed to the insurance company representing surety.

**Obligee.** The project owner and others, if there is a dual obligee.

**Penal sum.** The amount of the bond; generally, the amount of the construction contract.

**Premium.** The cost of the bond.

**Principal.** The entity requesting the bond (for example, the contractor, subcontractor, architect, engineer, and so on).

**The letter of credit**

Not quite a substitute for a bond, a letter of credit can be used in those instances where a bond is not available to a contractor or subcontractor who may have reached their bonding limits. A contractor’s inability to furnish a bond does not necessarily indicate lack of financial strength; contractors have bonding limits and a bonding company may wish to have a contractor, near or at their limit, complete a current bonded project before being issued a new one.

A bank-issued letter of credit (LOC) is a cash guarantee whereby the bank would freeze a certain portion of the contractor’s, or subcontractor’s, liquid assets in an amount equal to the value of the LOC. If commitments under which an LOC is issued are not met, the owner would then “call” the LOC and receive its proceeds.

There are three basic types of LOCs.

- **Conditional** Requires some burden of proof from an owner that the contractor has failed to perform in some respect
- **Stand-by** Deals with payment of a specific sum within a particular period of time
- **Transactional** Applies to a specific transaction
The bonding process

High bonding limits are prized by contractors since, in the eyes of the industry, it conveys strength—both in performance and in financial matters. The initial procedure for obtaining bonding is, in itself, a process referred to as the three Cs: character, capital, and capacity, as explained next:

- **Character** The reputation that the contractor has in the community; essentially, a track record of the successful completion of projects, and the absence of excessive litigation
- **Capital** Strong financial statements and evidence of good accounting practices
- **Capacity** Strong management, a history of producing profitable projects, a history of acceptable estimating, and the adoption of cost control procedures

Prequalifying for a bond

A bonding company will require the contractor to furnish documents that provide an in-depth look at their organization. Among the information included is

- An organization chart of key employees, noting their responsibilities and including their resumes
- A business plan outlining the type and size of work sought, prospects for that work (a sales development plan), the geographic area in which the company plans to work, and a statement of growth and profit goals
- Current work in progress, a history of completed projects (with name, address, phone/e-mail of owner), including contract sum, completion date, gross profit earned, and current backlog of work
- A continuity of business plan, outlining how business will continue upon death or retirement of the present owner; life insurance policies on key personnel required
- Evidence of a bank line of credit
- Letters of recommendations from owners, architects/engineers, subcontractors, and major suppliers

Financial statements must accompany the application and should include the following:

- Fiscal year-end statements for at least the past three years, along with the latest audited and certified statement
- A balance sheet showing assets, liabilities, and net worth
Income statement showing the gross profit on contracts, operating profit, and net profit before and after provision for taxes

A statement of cash flow

Accounts receivable and payable schedules

A schedule of general and administrative expenses

Explanatory footnotes—qualifications made by the accountant

A management letter conveying the CPA's findings, observations, and recommendations

A Grant Thornton study in 2005 compared the change in importance of the various criteria involved in obtaining bonding between the period 1996 and 2005. It's interesting to see how bonding companies have shifted their emphasis on some basic issues, while others remain essentially the same. See Table 4.1.

Insurance

Standard contract insurance requirements are generally limited to Commercial General Liability (CGL) and Contractors Professional Liability insurance (CPL). The CGL policy offers third-party coverage to the contractor, arising out of its operations and premises that may be either owned by, or under the control of, the contractor. It provides bodily injury and property damage liability coverage.

### TABLE 4.1 The Shift in Bond Issue Importance

<table>
<thead>
<tr>
<th>Criteria</th>
<th>2005</th>
<th>1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strength of balance sheet</td>
<td>98%</td>
<td>90%</td>
</tr>
<tr>
<td>Financial statement presentation</td>
<td>97%</td>
<td>91%</td>
</tr>
<tr>
<td>Equity</td>
<td>92%</td>
<td>75%</td>
</tr>
<tr>
<td>Debt</td>
<td>81%</td>
<td>68%</td>
</tr>
<tr>
<td>History of successful projects</td>
<td>81%</td>
<td>68%</td>
</tr>
<tr>
<td>Consistent profitability</td>
<td>78%</td>
<td>63%</td>
</tr>
<tr>
<td>Experience in type of project</td>
<td>78%</td>
<td>63%</td>
</tr>
<tr>
<td>Use of CPAs with industry knowledge</td>
<td>75%</td>
<td>68%</td>
</tr>
<tr>
<td>Claims history</td>
<td>67%</td>
<td>Not available</td>
</tr>
<tr>
<td>Reputation of firm and principals</td>
<td>66%</td>
<td>65%</td>
</tr>
<tr>
<td>Financial statement disclosure</td>
<td>65%</td>
<td>70%</td>
</tr>
<tr>
<td>Accounting practices</td>
<td>63%</td>
<td>59%</td>
</tr>
<tr>
<td>Experience in geographic area</td>
<td>59%</td>
<td>43%</td>
</tr>
<tr>
<td>Size of over/under-billings</td>
<td>55%</td>
<td>36%</td>
</tr>
<tr>
<td>Overhead expenses</td>
<td>47%</td>
<td>35%</td>
</tr>
<tr>
<td>Contract volume</td>
<td>36%</td>
<td>33%</td>
</tr>
<tr>
<td>Succession planning</td>
<td>30%</td>
<td>Not available</td>
</tr>
<tr>
<td>Safety record</td>
<td>10%</td>
<td>20%</td>
</tr>
</tbody>
</table>
Contractors Professional Liability insurance (CPL) provides payment on behalf of the contractor for damages resulting from bodily injury and/or property damage caused by the insured and arising out of ownership and maintenance or use of the premises where construction operations are taking place. Umbrella liability coverage provides coverage in excess of that provided by the underlying liability insurance policy.

Builder's risk
Generally excluded from a general contractor’s basic insurance requirements, unless otherwise required, builder’s risk—also known as course of construction insurance—provides coverage for loss or damage to the structure incurred during construction.

Two basic types of builder’s risk insurance exist:

- **All risk**  Covers all risks except those expressly excluded
- **Named peril**  Covers only certain risks identified in the policy

Workers' compensation insurance
Contractors are very familiar with workers' compensation insurance, which is required by the state in which they're operating, but are project managers conversant with how a poor accident record affects these insurance premiums? A bad accident record requires three years of good experience before workers' compensation insurance rates are lowered.

Premiums are established using the following formula:

$$WCIP = EMR \times Manual\ rate \times Payroll\ units$$

WCIP stands for Workers' Compensation Insurance Premiums.

EMR is Experience Modification Risk, the multiplier determined by the previous work experience of the contractor, which is used to forecast future benefit payments to employees who have filed claims.

Manual rate is the rate structure assigned to each type of work performed. Various trade crafts are classified into “families” based on their potential exposure to injury. Each “family” is assigned a four-digit number corresponding to their premium rate, which takes into account the worker accident claims experienced for that particular family of trades.

Payroll units is a number determined by dividing the contractor's annual direct labor costs by 100. A poor accident record can increase worker compensation insurance premiums to the point where the company’s overhead must be increased to compensate for these costs, making them less than competitive on hard-bid projects.
Subcontractor default insurance
When it becomes necessary to have subcontractors bonded, but a particular subcontractor cannot obtain a bond, the general contractor can inquire about subcontractor default insurance. This coverage includes reimbursement of costs incurred to complete the unfinished portion of the subcontractor’s work, in case of default. These types of policies generally involve a deductible, a copayment percentage, and an upper limit of liability. The insurance company will assess the general contractor’s method of prequalifying and managing the subcontractor by reviewing their management procedures and policies. The cost of the policy is determined by project size and geographic location, among other criteria.

Controlled insurance programs
A controlled insurance program, more commonly referred to as CIP or OCIP (owner-controlled insurance program), has been around since the mid-1960s, but has gained popularity the last 10 years as a way to control insurance costs while still maintaining the desired coverage.

The program. When initiated by a general contractor, the CIP is basically a wrap-around process, allowing the contractor to use their greater purchasing power to buy all of their CGL and CPL insurance for the project. Each subcontractor thus provides a credit for the cost of project insurance they would have included in their bid.

The OCIP works the same way, except that not only the subcontractors but also the general contractor provide the owner with a credit equal to the price tag of their combined insurance costs, excepting auto-liability coverage. The differences between conventional insurance coverage and the CIP approach are rather straightforward, as shown in Table 4.2.

A typical exhibit to a subcontract agreement advising of CIP and requiring the subcontractor to provide that insurance not included in the controlled program is shown in Figure 4.1.

<table>
<thead>
<tr>
<th>TABLE 4.2</th>
<th>The Differences Between Conventional Insurance Coverage and the CIP Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Coverage</td>
<td>Conventional Approach</td>
</tr>
<tr>
<td>Workers’ compensation</td>
<td>Each contractor and subcontractor</td>
</tr>
<tr>
<td>CGL</td>
<td>Owner, gen. contractor, subcontractor</td>
</tr>
<tr>
<td>Builder’s risk</td>
<td>Owner or contractor</td>
</tr>
<tr>
<td>Auto liability</td>
<td>Contractor, subcontractors</td>
</tr>
</tbody>
</table>

*Some states offer workers’ compensation directly to contractors and subcontractors.
EXHIBIT B: Subcontractor, Sub-Subcontractor Provided Insurance

This project is an Owner Controlled Insurance Program (OCIP) Project. Therefore, much of the insurance necessary for the project is provided by the OCIP. There are, however, additional insurances requirements for “off site” liability exposures that are required in the OCIP manual. There are also additional insurance requirements under this Exhibit B.

Each Subcontractor of every tier shall purchase and maintain the following insurance (s) during the term of this Project:

Automobile Liability insurance for not less then:

$1,000,000. Bodily injury/Property Damage Combined Single Limit.

This Insurance must apply to all owned, leased, non-owned or hired vehicles to be used in the performance of the Work, and the policy shall include an Additional Insured Endorsement naming the Owner, its directors, officers, representatives, agents and employees, Construction Manager, and Developer as an Additional Insured with respect to their operations at the Project Site.

Coverage is primary and non-contributory with respects to Owner, its directors, officers, representatives, agents and employees, Construction Manager, and Developer.

NOTE: Automobiles are defined in accordance with the 1986 ISO insuring agreement. This definition includes, but is not limited to, a land motor vehicle, trailer or semi-trailer designed for travel on public roads, whether licensed or not (including any machinery or apparatus attached thereto).

Workers Compensation, including Employers’ Liability Insurance with minimum limits of:

(a) Workers’ Compensation- Statutory Limits with Other States Endorsements
(b) Employers Liability

$1,000,000. Bodily Injury with Accident – Each Accident
$1,000,000. Bodily Injury with Disease- Policy Limit
$1,000,000. Bodily Injury with Disease- Each Employee

To protect Subcontractor and Sub-subcontractor from and against all workers compensation claims arising from performance of work outside the project site under the contract.

FIGURE 4.1 An exhibit to a subcontract agreement advising of CIP and requiring the subcontractor to provide that insurance.

OCIP and CIP programs are generally not cost-effective for small projects since the effect of combining premiums for all general and subcontractors may not result in sufficient savings to offset the added costs to administer the program. But on large projects, significant savings can accrue, and by combining all of the insurance premiums for all of the companies working onsite, the insured can present one large account for insurance companies to bid on, rather than a number of small accounts.

However, everything comes with a price. Unless the general contractor or owner has a strong safety program in place, backed up by a full-time Safety Supervisor, an accident prevention program that isn’t effectively controlled could drive insurance premiums through the roof.
Bonds and Insurance

General Liability Insurance for contract operations not physically occurring within the Project Site. Five (5) Year Completed Operations Coverage Extension with a limit of liability not less than:

- $1,000,000 Per Occurrence
- $1,000,000 Personal Injury and Advertising Injury
- $2,000,000 General Aggregate (On a Per Project Basis)
- $2,000,000 Products/Completed Operations Aggregate

The Coverage to be written on the ISO standardized CG 00 01 (10/01) or substitute form providing equivalent coverage. Such insurance shall cover liability arising from premises, operations, independent contractors, products-completed operations, personal and advertising injury, and liability assumed under an insured contract (including the tort liability of another assumed in a business contract). Such policy shall include an Additional Insured Endorsement naming the Owner, its directors, officers, agents, represents and employees, Construction Manager, and Developer as additional insured’s.

IMPORTANT – The additional insured endorsement shall be maintained for a minimum period of at least (5) five years after end of the project completion. This endorsement wording should be equivalent either of the following ISO endorsements:

- CG 20 10 (11/85)
- Both CG 20 37 (10/01) and CG 20 10 (10/01)
- CG 20 26 (11/85)

Coverage is primary and non-contributory with respects to Owner, its directors, officers, representatives, agents and employees, Construction Manager, and Developer.

Wrap up exclusion to be removed five (5) years after completion of your work.

Excess Liability insurance written on an occurrence form for contract operations not physically occurring within the Project Site. Five (5) Year Completed Operations Coverage Extension with a limit of liability not less than:

Subcontractors of all tiers
- $5,000,000 Per Occurrence
- $5,000,000 Annual Aggregate

FIGURE 4.1 (Continued.)

Insurance terms

Interpreting the insurance lingo is sometimes confusing. Thus, the following glossary was created to help you decode some of the terms used.

Additional insured. An entity other than a named insured who is to be protected under the terms of the policy. Usually these additional insured are added by “endorsement” or referred to in the policy as such.

Aggregate limit. The maximum amount of coverage that an insurer will pay for all losses during a specific period of time (usually the coverage date) no matter how many claims are made.
Excess Liability insurance will include coverage for Automobile Liability for the, Subcontractor, Sub-subcontractors while on-site and off-site.

Such policy shall include an Additional Insured Endorsement naming the Owner, its directors, officers, agents, represents and employees, Construction Manager, and Developer as additional insured’s.

**Contractors Equipment insurance**, for all construction tools and equipment whether owned, leased, rented, borrowed or used on Work at the Project Site is the responsibility of the Subcontractors and Sub-subcontractors, the Owner or Construction Manager shall not be responsible for any loss or damage to tools and equipment. The Contractor’s Equipment insurance shall include a waiver of subrogation against the Owner, its designee(s), Construction Manager, Developer, other contractor(s) and subcontractor(s) of all tiers to the extent of any loss or damage. If the Subcontractor or Sub-subcontractor does not purchase such insurance, he will hold harmless the Owner, its designee(s), broker(s), Construction Manager, Developer, other contractor(s) and subcontractor(s) of all tiers for damage to their tools and equipment.

**Waiver of Subrogation**

Subcontractors at every tier shall require all policies of insurance that are in any way related to the Work and that are secured and maintained by the Subcontractor and all tiers of Sub-subcontractors to include clauses providing that each underwriter shall waive all of its rights of recovery, under subrogation or otherwise against the Owner, their designee(s), broker(s), Construction Manager, Developer, contractor(s) and all tiers of subcontractors.

Construction Manager shall require Subcontractors and all tiers to waive the rights of recovery (as aforesaid waiver by Construction Manager) as stated above.

**Notice of Cancellation/Termination**

Each Certificate of Insurance shall provide that the insurer must give the Construction Manager at least 30 days prior written notice of cancellation and termination of the subcontractors and sub subcontractors coverage there under.

**Insurance Carrier**

Insurance Carrier must be licensed to do business in the State of (or whichever state in which work is being performed) and have a Best Rating of A VII or better.

**FIGURE 4.1 (Continued.)**

**All risk insurance.** A policy against damage to the property written to insure all risks of loss or damages, as opposed to a policy insuring against “named perils”—that is, specific hazards against which the policy insures. However, all policies exclude insurance against some hazards, so this is actually a misnomer.

**Annual aggregate limit.** The maximum amount payable under an insurance policy for all losses occurring during a calendar or fiscal year.

**Blanket insurance.** Insurance that covers more than one type of property in one location, or one or more types of property in several locations.
Broad form property damage insurance. Covers damage to work installed by, or on behalf of, a contractor.

Business interruption insurance. A temporary shutdown of a company’s activities due to physical damage to its property or another’s property. Generally provides reimbursement for salaries, taxes, rents, and other continuing expenses during shutdown, and also includes loss of net profits which would have been earned during the period interruption.

Care, custody, and control. A frequent exclusion in liability insurance denying coverage of the insured’s liability for damage to another’s property while in the insured’s care, custody, or control.

Coinsurance. A provision that obligates the insured to either purchase insurance to a specific percentage of the total value of the insured property or to bear a fraction of each loss in proportion to the deficiency in the amount of the insurance purchased.

Combined single limit. A single limit of liability coverage for bodily injury and/or property damage.
Commercial General Liability insurance (CGL). A broad form of insurance coverage for the legal liability of an insured for bodily injury and property damage arising out of operations, products, and completed operations and independent contractors—but excluding coverage for liability arising out of the use of automobiles.

Comprehensive General Liability insurance. Same as preceding entry. The name previously used for this insurance.

Endorsement. Document attached to a policy which modifies the policy's original terms.

Excess limits. Limits of liability that may be purchased in excess of the limits included in the basic policy.

Extended reporting period endorsement. A device offered by insurers writing a claims-made form whereby the coverage is extended to future claims that may be reported, or that may occur after the expiration of the policy under which the claims had been made.

Fidelity bond. Insurance that protects an insured employer against loss of money or other property due to the dishonesty of an employee.

Owners’ and contractors’ protection liability. Coverage to protect an owner and contractor for any liability incurred as the result of independent contractors employed by the owner or contractor.

Products liability insurance. Coverage protecting the insured for liability arising out of defects in products manufactured, sold, or distributed by the insured.

Professional liability. Liability for injury, personal injury, death, and property damage arising out of the negligent act or omission of a professional (with respect to construction, this would include an architect, engineer, or attorney).

Single limit. Maximum of the insurer’s liability for all types of bodily injury, property damages, or personal injury claims arising out of one accident, regardless of the number of persons incurring an injury.

Retro date. The inception date of the first policy written on a claims-made basis.
Split limit. Separate limits for bodily injury and property damage claims. These policies contain three separate limits: one for bodily injury to each insured person, one for bodily injury to two or more persons injured in the same accident, and one for property damage per accident.

Subrogation. The legal right of anyone who has paid an obligation owned by another to collect from the party originally owning the obligation. An insurer, after paying the insured for damages incurred, may attempt to recover damages from the third party that actually created the damages.

Subrogation waiver. A waiver by the named insured giving up any right of recovery from another party.

Tail. An insurance term referring to the lapse of time between the occurrence of an accident and the eventual resolution of any related claims.
Bonds and Insurance