ARE YOU PAYING TOO MUCH FOR YOUR SURETY BONDS?

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Many contractors are not aware that they are paying too much for their surety bonds. The purpose of this article is to discuss the bond transaction, share select experiences, and outline the services you should be receiving from your surety bond representative. This will help you determine whether or not you are getting an adequate return on your bonding relationship.

As in all purchases, the benefit from the product or service must be compared to the cost. A good business deal or lasting affiliation occurs when the benefit derived from a product or service is equal to, or greater than, the cost and time investment of that purchase. It seems simple, but the evaluation is more complex when you incorporate perception versus reality, sales pitch versus substance, tangibles versus intangibles, and the actual added value associated with the product and related service.

The perception of most contractors is that the bond cost is only the dollar value quoted on the bond. The contractor is provided a rate structure by his/her agent or surety. The contractor performs the necessary calculation and comes up with a price for the bond. Is this the true cost?

Who is really paying for the bond? The cost of the bond is a direct cost to the contractor, in contrast to an overhead cost. The contractor incurs no cost for the bond if he does not receive an award on the contract. The cost of the bond is actually paid for by the owner, not the contractor. It is a pass-through cost for the contractor.

Surety is different from most products. Primarily, the owner is the beneficiary of the bond. Suppliers and subcontractors also receive some benefits from the bond. The beneficiaries of the bond have little, if any, contact with the bond company at the point of purchase. Although the contractor does not pay for the product(bond), the sureties generally perceive their client as the contractor, the party that receives no direct benefit from the bond instrument.

The astute contractor does realize a value to his/her surety relationship. First, the contractor can increase income by obtaining increased surety credit, if and only if, the contractor's organization has the abilities, expertise, finances, and systems to support such a program. The contractor (himself and through his agent) must instill confidence in the surety to support his/her wants and needs. Second, the agent and surety should provide valuable insight into the marketplace. Although they cannot, and should not, share confidential information, they can share perceptions, trends, ideas, etc. A value achieved with no cost to the contractor.

If the owner is actually paying for the bond, why then is there a price war in the bond industry? Naturally, the lower the cost of the bond, the more competitive the contractor can be on a job. Although the lower bond cost can enhance the contractor's competitiveness, the differences among most companies surety rates are very small. Rarely does the rate differential impact the outcome of a bid. Therefore, it is more important for the contractor to look closely at the overall benefits available from his/her surety representative.

Let's review a few bond related experiences. What were the true costs and benefits to the contractors involved in the following situations?

(1) A large contractor from the Northeast acquired a large private contract that required a performance and payment bond. Rather than providing bond forms that paralleled the obligations under the contract, the surety representitive provided bond forms that actually increased the exposure to their contractor. A subcontractor on their job went bankrupt. There were considerable unpaid invoices from their suppliers whom were second tier subs/suppliers. The contract stated that the General Contractor was only responsible for subs and suppliers with direct conracts with the General Contractor. However, the bond form utilized expanded their responsiblities to second tier subcontractors. The use of the wrong bond form cost the contractor approximately $200,000. The additional cost came directly out of the contractor's retained earnings. A significant cost for the contractor to assume, especially since it could have been avoided utilizing the services of a seasoned bond representative.

(2) A contractor bid a job which resulted in a significant spread between the first and second bidder. The contractor's estimator stated he was comfortable with his bid. The surety rep, having some

knowledge of the construction marketplace, the type of job, and the competitors, felt uncomfortable with the bid. Therefore a meeting was arranged with the owner, architect, contractor and surety rep. During the meeting, two things became clear: (a) the architect expected the price to come in much higher than the low bidder's price; and (b) the surety rep was able to explain the likely outcome of the job to all three parties if the contractor's bid price was indeed inaccurate and they were contracted to perform the job. As a result of the meeting , the architect agreed to talk to the second and third bidder to evaluate the integrity of the bid estimate and the surety rep agreed to obtain an independent review of the bid numbers.

The result of the independent review and the architect's discussion with other bidders was the realization that the contractor missed some aspects of the job and made some incorrect assumptions. The contractor's bid price was substantially less than their costs. Subsequently, the owner and architect agreed to let the contractor out of the job and waived the bid penalty. Considering the actions of the surety representative, the contractor avoided losing a substantial amount of money.

(3) A contractor received a mailer from an agent stating he could provide a bond at a lower cost for a job in which the contractor was recently low bidder. The contractor, excited about the savings of a few thousand dollars, bought into the sales letter. In the short term, the contractor saved a couple thousand dollars. However, the long term was not as rewarding. When the contractor wanted to bid a sizable job, the surety declined the risk; a job size in which their prior surety had supported in the past. The potential loss of income on the job was approximately $200,000. Was the small savings worth the long term loss?

The three examples above reinforce the cost of compromising on the abilities of your bond representative. Generally, the surety reps that sell lower rates have very little to offer a contractor. The contractor should acquire a surety agent who can provide the most support in terms of legal, accounting, banking and market knowledge, along with business acumen, and strong surety relationships.

<u>Your Surety Bond Representative need not be :</u>

* A **CPA -** however, your representative should have a thorough understanding of construction accounting;

*A **Lawyer** - however, he/she should have a good understanding of business law as it relates to construction;

*A **Former Contractor** - however, your representative must understand the construction process from the invitation to bid to the expiration of construction warranties and all the critical events in between.

If you desire a reasonable benefit from your surety to enhance long term profitability, it is important to evaluate the following nine questions. After reflecting on these questions, you will be able to determine whether or not you are acquiring your bonds for a reasonable cost.

1. Does your surety representative have:
   (a) Construction or business acumen?
   (b) The experience to get the job done?
2. Is your agent accessible if and when a problem arises? Does he/she contribute solutions to your problems and needs?
3. Does he/she have a sincere interest in your company <u>beyond</u> the income derived from your account?
4. Does your surety representative explain the surety's wants and needs in such a way that you understand what they need and why?
5. Does your surety rep.listen and try to under stand your interests or does he/she get lost in the numbers game?
6. Does your surety representative ask where you want your organization to go and identify a structure on how to get there?
7. Is your surety representative an asset to your firm, or a "necessary evil"?
8. Does your surety representative have a sufficient network established with the important peripheral players necessary to enhance your company's profitability over the long term?
9. Are you totally satisfied with your current surety relationship?

If you can reflect positively on these questions and are getting the service you deserve (regardless of the dollar cost on the bond), **you are <u>not</u> overpaying for your bonds.** Conversely, if these questions prompt inadequacies in your surety relationship and you are not receiving the proper servicing , you are likely paying too much for your bonds.

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