

# The Importance of Surety Bonds



Ken Goodwin, Vice President, Surety Division, with Poms & Associates Insurance Brokers, LLC, in Walnut Creek, has a background in sales, marketing, finance, underwriting and surety bonding. Although, as he says, “No one comes out of college wanting to become a surety broker,” he has found this niche to be particularly fulfilling because of how vital it is to ensuring that construction contractors can participate in public works projects. Ken sat down with *Contractor Tools* to provide our readers with some important details about surety bonds.

## Types of Surety Bonds

“The first thing to understand is that the term ‘surety bond’ is a catch-all for a number of different types of bonds – including contract, license, permit, court and other types of bonds,” explains Ken. “However, our firm focuses on construction contract bonds and subdivision improvement bonds.”

A bond is an agreement in which one party guarantees that the other party will follow through upon an obligation to the obligee (the party to whom the obligation is owed). "So when a public agency requires a contractor bond a project, the contractor's surety bond is guaranteeing that the contractor will complete the project per the contract specifications and requirements." Thus, should the contractor fail to perform as agreed, or not pay his subcontractors and suppliers, the project owner can file a claim against the bond if the terms and conditions were not met.

As Ken outlines, a construction contract bond is different from a contractor's license bond because the contract bond is tied to a contractor meeting the terms and conditions of a specific contract, whereas a license bond protects a contractor's clients from poor workmanship or malfeasance by guaranteeing that the contractor will abide by the requirements of that license. If a contractor doesn't meet the professional standards of his or her profession, then a client can file a claim against his/her license bond.

Approval of surety credit requires an extensive underwriting process to weed out potentially high-risk contractors. "When a surety is extending credit, they have to be able to trust that your financial information is accurate and credible. Since the bond is in place to protect the client from a failure of the contractor to perform to the terms and conditions of the agreement, it is vital that the surety bond underwriting process ensures that the contractor is not likely to fail in performing the contract," says Ken. He advises that contractors avoid a bond claim at all costs.

### **Preparing for the Underwriting Process**

A good surety broker will counsel contractors on what areas they will need to strengthen prior to applying for a bond. "Your surety broker will need to learn everything about you and will gather and analyze the information required for underwriting, this includes business and personal financial statements. A good surety broker should know what the underwriters are looking for and will want to help you prepare to ensure that you have the highest likelihood of securing bonding," notes Ken.

Of key importance in preparing to apply for bonding is ensuring that your personal and business financials are strong and well documented. "Take good care of your personal and business financial health because it is the most important factor in securing bonding credit," emphasizes Ken. "Although sureties always look to your business financials first, your personal financials - including your credit rating - also play a large role."

He shares that some contractors initially don't like the idea of having to illustrate their personal creditworthiness or having to personally back their company, but points out, "Why should a surety company extend credit to you if you have no skin in the game? If you are not willing to personally back your company, why should the surety company back your company?"

## THE IMPORTANCE OF SURETY BONDS

As he explains, it's nearly impossible to avoid personal indemnity. "If contractors want to perform public works projects, they must have two to three years of strong financials to show that they can cash flow their operations. This means having good credit, having equity in their company, strong supplier relationships, and not having a lot of debt. This is the information that must be reviewed for underwriters to determine if you are bondable."

Ken suggests working with a CPA as soon as possible to get professional assistance in setting up financial record-keeping systems, such as QuickBooks or similar programs, and in creating personal and business financial statements. "The credibility and accuracy of the numbers and their presentation are vital, so it is important to invest in and learn how to use a decent internal accounting system."

Finding a good surety bond broker is key.

Ken recommends asking the Contractor Development Program staff for referrals, checking with contractor friends and colleagues to see if they have a broker they are happy with, asking your existing insurance agent, or finding a broker through the **National Association of Surety Bond Professionals (NASBP)**. "Try to find a surety bond producer who has experience in construction bonds and specialty knowledge of underwriting requirements and appetites; a good broker should be able to suggest improvements for you to strengthen your firm and should know a good CPA, attorney and other business professionals to support you."

### **Determining Your Bonding Capacity**

If you are a new contractor, you won't have a track record of completing projects, so a surety broker will want to see that you can cash flow the project for which you want to bond.

"Some surety markets have 'quick bond' programs that offer surety credit up to \$750,000 for



*Ken Goodwin, Vice President, Surety Division, with Poms & Associates Insurance Brokers, LLC.*



single projects with an aggregate of the same amount. These programs rely heavily on the contractor's credit score. This entry-level program can help your company develop a track record to establish surety credit," says Ken, "and at that point, you can start looking at larger jobs. However, one of my biggest challenges is managing contractors' expectations, because it's my job to keep them from taking on more risk than the industry will allow. You have to prove that you can complete the project for which you're trying to get bonded and that you have the financial strength to cash flow that project."

A contractor's bonding capacity is determined after all personal and business financials documentation has been submitted. "If you qualify for up to \$750,000 in bonding, then you must perform jobs in that range or less to build your track record, put in place financial reporting systems, invest money back into your company, ensure that your jobs are profitable, and establish a line of credit," summarizes Ken.

Ken emphasizes that contractors need to grow their business in a sustainable manner. "If you want to perform larger jobs, you just have to take it slow. I have clients who started out small and are now doing \$11 to 12 million jobs because they were smart, they listened to my advice and they didn't try to grow too fast. If you take too large a risk or are not ethical, it will come back to bite you. When you do start making a profit, that is not the time to pull money out to buy expensive real estate, cars and other unnecessary luxuries – spending like that can degrade your company's equity and working capital and will be detrimental to your long-term success."

### **Conclusion**

Surety bonding in construction addresses the project owner's need to have a guarantee that the contractor with the winning bid will follow through to meet the terms and requirements of the contract. "In some ways, brokers are almost like therapists," reflects Ken, "because we help sort out and counsel our clients on issues that can affect their ability to bond. Your surety broker wants to help you succeed and will be honest with you about what you need to do in order to qualify for bonding and what amount is realistic based on your financial strength and experience."

Ken encourages contractors to get started right away on setting up the systems and practices that will put them in the best position possible when applying for bonding. "It doesn't have to be overwhelming if you get the right guidance and support, and you will feel a great sense of relief when you know you're on your way to being able to bond."

**For more information about Poms & Associates Insurance Brokers, LLC or to get in touch with Ken, visit the company [website](#).**