2007 Surety Market Report Rising to the Occasion

By Marc Ramsey, Surety Information Office (SIO)

Surety is a cyclical business. Like a cruise line in rough seas, the industry withstands plunging waves of severe losses by catching intermittent waves of profitability. And that characteristic is one of the biggest values to the construction marketplace. It smooths out the results for obligees to the extent that the surety industry pays for the volatility in the construction cycle.

In 2005, the surety industry rose from the depths of several years of record losses, floating atop a tide of profitability that surged through 2006 with a 16.2% loss ratio for all surety (contract and commercial), according to industry statistics provided by The Surety & Fidelity Association of America (SFAA).

“Last year’s extraordinary performance was a perfect confluence of several positive events coming together,” explains Dennis S. Perler, president, Liberty Mutual Surety. “Strong construction spending and larger profitable contractor backlogs joined with responsible underwriting driven by lessons learned from prior period losses to restore profitability and stable capacity to the industry.”

Indeed, written surety premium grew a healthy 11% in 2006. Bonded contract values grew substantially due to material inflation on core construction materials. “While inflation contributed to increased revenues,” Perler continues, “the strong construction economy and higher contractor bond utilizations helped produce in 2006 the perfect factors for the surety industry to be profitable. But surety is a long-term credit-driven product. To sustain bonding capacity necessary to support the construction industry, the surety industry needs to exercise continued responsible underwriting and management. As we talk about a very successful year, we need to remember that 2006’s strong result has merely restored the product line to breakeven for this decade.”

NEW OPPORTUNITIES

The surety industry faces new challenges. “The surety industry,” says Rick Kinnaird, SFAA board chairman, and senior executive, surety, Westfield Group, “needs to understand changing insurance coverages and new trends such as public-private partnerships and broaden our focus beyond the traditional underwriting process of the past 50 years. There are a lot of new issues that we need to address and are addressing.”

For example, some project owners—both public and private—are bundling projects together, including ones that are completely unrelated. This bundling discourages competition, inflates pricing and prevents contractors from growing through experience. “The trend to consolidate normal construction projects into megaprojects is troubling in that it reduces opportunities for local contractors,” Perler notes. “Without these opportunities, local contractors may find it difficult to sustain their current backlog levels.”

Meanwhile, public private partnerships are emerging as public owners look for capital to execute their plans. “Both sureties and owners are in the process of developing alternative procurement models that result in acceptable levels of risk assumption by all parties, including contractors, developers, operators and sources of private equity and project financing,” says William A. Marino, chairman and CEO, Allied North America.

SMALL MARKET

Executives contend there are plenty of surety competitors in this market with the capacity to support contractors’ bonding needs under $1 million. However, underwriting can be fairly stringent with collateral required in many situations. This may create somewhat of a barrier to entry for some contractors in this market. “It is important that we continue to work with new and emerging contractors,” SFAA’s Kinnaird emphasizes. “We need to address the needs of all levels of contractors.”

The more sophisticated small contractors are, the more attractive they will be to the surety. This means using computer software systems, construction management systems, externally produced financials, having bank credit, demonstrating longevity of management and having continuity of programs.

MIDDLE MARKET

The mid-sized construction market (around $50 million) remains the most competitive arena in the surety market. This is the most dominant segment for both regional and national surety providers. Executives insist there is more than adequate surety availability and capacity.

While underwriting in this market has been relatively rational, there does appear to be some loosening of underwriting standards in some isolated markets.

Some surety executives also are seeing additional capacity from existing surety players in this market. “We’re not necessarily seeing new surety companies,” says Tom Kunkel, president and CEO, Travelers Bond & Fidelity Association of America (SFAA). “Top 10 Writers of Surety Bonds—United States & Territories & Canada,” 2006 (Preliminary); www.surety.org.

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<thead>
<tr>
<th>Companies</th>
<th>Direct Premium Written (millions $)</th>
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<tr>
<td>1. Travelers Bond</td>
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<td>2. Zurich Insurance Group</td>
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<td>7. Hartford Fire &amp; Casualty Group</td>
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<td>9. HCC Surety Group</td>
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<td>10. American International Group</td>
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*INCLUDES CONTRACT AND COMMERCIAL SURETY

ers Bond, “but those in the middle market are providing higher levels of capacity than they would have two and three years ago.”

**LARGE MARKET**

Larger sureties are pleased with the performance of their larger contractor portfolios and appear to be willing to expand capacity commitments for the larger and better capitalized construction companies ($250 million+). “Rather than stretch underwriting standards in the middle market,” explains Michael J. Cusack, senior vice president, managing director and operations board member, Aon Construction Services Group, “sureties are willing to expand capacity for larger clients with whom they have existing relationships.”

There has been some consolidation in this market, so several construction firms need $5-billion and $10-billion work programs. “But with the right contractor and right co-surety partners, those kinds of work programs can be put together,” insists Terry Lukow, executive vice president, Travelers Bond, Construction Services.

**GROWTH CONSTRUCTION MARKET**

“The construction boom,” says Aon’s Cusack, “is still alive and well for the majority of the United States. The Northwest, West, South, South-east, and Mid-Atlantic all continue to enjoy a very robust construction economy.”

“There is not a segment in the construction industry that we do not see growth in,” Travelers’ Lukow declares. “This is the first time in my 33-year career we’ve seen this.”

There are signs that the vitality of this market will hold for another couple of years. “Architects and engineers, for instance, indicate that their coffers are full and that they continue to seek qualified professionals,” observes Terry Cavanaugh, chief operating officer, Chubb Surety.

The surety product will serve an important role during this continued growth market, particularly with the reinvestment in the U.S. infrastructure, but also because of the increasing complexity of today’s construction projects. “The value of the surety product will be needed more than ever,” advises Sarah Finn, president, National Association of Surety Bond Producers (NASBP), and national surety vice president, IMA of Colorado.

A growing construction market does not come without some concerns. In addition to citing commodity volatility and contractual risk, surety executives are concerned about labor shortages. With the graduating class in all of the construction industry for 2007 at 75,000, “The construction industry will absorb those 75,000, and could use another 75,000,” Travelers’ Lukow notes.

**UNDERWRITING**

Maintaining underwriting discipline, surety industry executives agree, will enable qualified contractors to capture significant profitable work in this robust construction economy. “A loosening of underwriting discipline is a disservice not only to the construction community, but to the beneficiary of our product, the owner/obligee,” Chubb Surety’s Cavanaugh warns. “It is the owner/obligee who demands we prequalify the best available contractor or consortium seeking to bid their work. It is an obligation that is at the core of our industry principles and straying from those standards diminishes our product and services.”

Meanwhile, sureties are being asked to support larger project contracts and overall work programs primarily caused by inflationary issues. “Unfortunately we do not typically see a corresponding increase in equity,” explains Michael P. Foster, executive vice president, Merchants Bonding Company (Mutual). “Sometimes this is planned for tax or continuity reasons. Therefore we are being asked to support larger bonds and programs based on balance sheets that are not proportionately larger. It is essential to confirm that the contractor has the management capacity to handle the larger jobs. This includes understanding the organizational structure of the company and monitoring the account closely through the review of quality interim financial information.”

If professional surety bond producers and underwriters are doing their jobs, they are asking contractors about the resources available to do existing work or new forthcoming work. “Do they have the people talent within their organizations to do the work?” asks Tim Mikolajewski, senior vice president, Safeco Surety. “Do they have the necessary equipment resources to do the work? Are they relying on a
critical subcontractor or supplier to perform for them, and if so, is there a way of mitigating that risk? Is the contractor getting the appropriate margin for the risk involved in the project?”

Project owners and contractors also should be aware that a strong economy allows weak contractors to cash flow their operation longer because of the availability of work. “Contractors can keep transferring loss from job to job,” explains William Cheatham, president, Zurich North America Surety. “The overall surety industry results are very profitable and stable. But there are some sureties experiencing adverse underwriting results. I don’t want people to lose fear, because this industry has a history of being volatile.”

“A loosening of underwriting discipline is a disservice not only to the construction community, but to the beneficiary of our product, the owner/obligee.”

—Terry Cavanaugh, Chief Operating Officer, Chubb Surety

SURETY OUTLOOK

While 2007 results are expected to be consistent with 2006, surety executives do anticipate some erosion in the industry’s loss ratios, primarily because it will be difficult to perform better than 2006. But 2007 and 2008, executives maintain, will be strong years for the surety market.

“The one thing that will happen in 2007,” ACSTAR’s Nozko says, “is more than 5,000 private and public project owners and lenders industry wide will avoid a loss by having a surety bond in place in 2007-08.”

So far, 2007 is showing strong results, if only a quarter into the year. “Anything can happen,” Chubb Surety’s Cavanaugh says. “Providing that underwriting discipline is maintained, there is no reason to believe surety results should not share in the profitable results contractors should realize during this strong construction market. Historically though, defaults are more prevalent during booming markets as organizations find their resources too stretched.”

Ultimately, the next two to three years should define whether the surety industry goes into a cycle again. “We’re at a period of risk where there is potential overextension by both the contracting and surety industries,” Zurich’s Cheatham believes. “Both contractors and sureties tend to be undercapitalized.”

Looking beyond 2007, surety executives are optimistic. “While there will be individual exceptions, I believe the surety industry as a whole will continue to enjoy strong profits in 2007 and likely, positive industry results will continue through 2008 and 2009,” predicts Doug Hinkle, chief underwriting officer, CNA Surety. “A disciplined surety industry and a strong construction market are the primary components in determining ultimate surety industry results.”

Marc Ramsey is the communications manager for the Surety Information Office (SIO) in Washington, DC. He can be reached at (202) 686-7463 or mramsey@sio.org.
SURETY MARKET REPORT
EXECUTIVE VIEWPOINTS

TOM KUNKEL
President & CEO
Travelers Bond

TERRY LUKOW
Executive Vice President
Travelers Bond, Construction Services

There is no question when you look at the small and middle market contractors that the competition has increased. It’s interesting from our perspective, looking at the economic performance of the surety industry and having two years of profitability under our belt and the industry is out competing again. It’s not irresponsible, but it’s at a higher level than it was. There has already been some loosening in underwriting and pricing discipline in the middle market.

We take a composite view of the whole contractor. We don’t support transactions. We’re in the business of supporting a strategic plan for a contractor. How are they going to plan, manage, and staff the work? We understand their strategic plan and buy into that plan.

The industry went back to its roots and became very disciplined in its underwriting approach, leading to a decrease in failure rates. The discipline that the surety industry has brought to the construction industry has made contractors better businesspeople. The industry forces the contractor to think more strategically than transactionally.

WILLIAM CHEATHAM
President
Zurich North America Surety

Surety availability is adequate and sufficient. Underwriting is reasonable. Large and international markets require more engagement. There are 100-plus surety competitors that participate in the small to middle market. It’s less predictable and more competitive as to terms and rates. It makes it more volatile.

We start with the three Cs: character, capacity, and capital. We require the full engagement with the contractor. We’re not just taking a financial statement. We understand the contractor and his or her expertise. We want to understand whether his or her business strategy closely aligns with our business strategy. It’s more than just, ‘I’m going to grow my business.’ We ask, ‘How are you going to manage your growth?’ You’ve got to dissect the company to understand it. Understanding risk is more than just the opportunity. What you want to hear about is their risk aspect. How are they going to manage that risk?

DOUG HINKLE
Chief Underwriting Officer
CNA Surety

Surety capacity is more than adequate for mid-sized and large contractors, and I expect continued improvement in capacity for the small and emerging contractor.

A significant increase in individual project size and total work program relative to past experience can present an overwhelming challenge to a contractor. Projects with increased size and scope often bring added complexity as well as different cash flow dynamics. Ensuring that the organization has the management in place, the accounting systems, equipment, and necessary capital to finance the growth is critical to achieving profitable project execution.

A healthy construction market plays a key role in any future prediction. Significant declines in construction spending would negatively impact surety industry results. We may well see slower growth in construction in 2008, but if current ranges in interest rates and overall economic growth can be maintained, I wouldn’t expect a fall in construction activity levels to the degree necessary to produce surety industry wide loss in 2008 or 2009, but a significant decline would result in increased loss activity.

TIM MIKOLAJEWSKI
Senior Vice President
Safeco Surety

The surety industry has met the needs of the growing construction economy well. Double-digit growth and strong profits have allowed sureties to reinvest in their businesses to keep their infrastructure up to speed with the demands of the market.

The biggest risk to owners in the current growth market is the fact most contractors have record high backlogs. Do contractors have the talent within their organizations to handle the work in their backlogs?

This is an ideal time for owners to mitigate that risk by requiring bonds on their projects, so they are assured a contractor is prequalified and that they have the protection of a surety bond if the contractors fail on a project.

The two biggest risks to contractors are talent availability and, for prime contractors, the availability of subcontractors. There is no question that in order to maximize their surety capacity, contractors need to have more than the basics—the basics being quality financial statements, cost controls, business planning (including business perpetuation), and talented, proven field management.

DENNIS S. PERLER
President
Liberty Mutual Surety

Contractors benefited from a rare alignment of solid construction spending, excellent profit margins and realistic construction capacity. With strong construction performance, the surety industry posted its best returns in decades as high contractor bonded backlogs and increased bonded contract values due to material inflation aligned with responsible underwriting to increase premium revenue and reduce loss expense.

But one good underwriting year does not signal a paradigm shift in the surety market. Even with excellent 2006 results, the overall cumulative surety industry result since 2000 is just about “breakeven.” As a highly volatile product dependent on large capital investments, the surety industry’s challenge is to demonstrate stable return on invested capital over time in order to sustain bonding capacity at levels necessary to support U.S. construction. When sureties underwrite well and manage their operations carefully, contractors benefit through access to stable and consistent long-term

SPECIAL ADVERTISING SECTION

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MARY JEANNE ANDERSON
Vice President, Surety Arch Insurance Company

A crystal ball sits on the corner of my desk. It is a gift from long ago, intended to divine the future of the construction economy, the legal environment and the ability of a particular contractor to successfully navigate the risks he faces everyday. I often wonder if the surety industry results would change if every underwriter had a decision-making crystal ball at his or her disposal.

Over the past 30 years, I have observed the specifics of surety underwriting grow increasingly more sophisticated. Technology has provided us with new tools and made the underwriting process more efficient. Legal and regulatory implications have become pervasive in all aspects of what we do. Yet the basic principles of underwriting have not changed.

On my first day as an underwriter, I was told that the job all came down to common horse sense. Faced with a barrage of new terms such as “net quick,” “obligee” and “acid test ratio,” I found this very hard to believe. Clearly, I had entered a magical world requiring tremendous concentration, effort and the ability to analyze something called a WIP if we were to be successful. That all proved true, but the real job started when that work was done and it was time to make the decision. It all came down to common horse sense and that has not changed. The success of our industry lies not in technology or legal white papers or top line growth, but in the discipline of looking past all those pressures and making common sense decisions.

As for the crystal ball, I don’t know if it works. But horse sense does.

MICHAEL P. FOSTER, AFSB
Executive Vice President
Merchants Bonding Company (Mutual)

The industry has been very profitable for the last 18 to 24 months. Because of this we are seeing additional capacity in the industry. There are some primary companies that are new to the industry and there are some primary companies who are participating at higher levels than they have in the past.

Underwriters and producers have a responsibility to assist their contractor clients in determining how the contractor will manage the increased capacity. We need to make sure that they have sufficient personnel with proper experience to handle the additional work. We also need to make sure that they have satisfactory subcontractor selection and management procedures. We need to make sure our subcontractor clients are not taking on too much work.

Escalating fuel prices continue to be a concern, especially for contractors performing highway work. Many asphalt projects are being withdrawn due to budgetary issues. Highway construction funds are tied to gasoline sales in many states. As gasoline prices increase, people will be driving less, which will result in a decrease in the amount of funds available for highway construction.

SARAH FINN
President, Nat’l Assn of Surety Bond Producers
National Surety Vice President, IMA of Colorado

Opportunities abound and most contractors are extremely busy, pursuing significant work programs. This success, in turn, presents the construction industry with some significant challenges, particularly in finding and retaining a quality workforce and to selecting the right projects to pursue.

Contractors need discipline, experienced management and resources to turn to for sound advice. The contractor’s professional surety bond producer and surety are key resources to assist the contractor to identify risk and the resources needed to manage risk for sustained growth and profitability. Bond producers will be a ready resource to help make sure that their clients have the right infrastructure in place to manage their projects. Producers want long-term business success for their clients and do not want them to outgrow their capabilities. Contractors can count on their producers to function as part of their invaluable strategic management team to identify resources and opportunities and to help them overcome today’s challenges and those in the coming years.

WILLIAM A. MARINO
Chairman and CEO
Allied North America

The surety industry will continue to provide the necessary support for deserving contractors who pursue work with equitable contracts and quantifiable risk. Deserving contractors have the ability to accurately forecast results and consistently deliver on those projections and place a high value on the professional relationship that contributes to their success.

As the Public Private Partnership model continues to evolve in the Unites States, the role of surety will continue to be defined. The sureties need to be there to assess and to influence the development of this model. Similarly, contractors need to understand this evolving procurement model and establish relationships with joint venture partners and professional service providers that are capable of managing the associated exposures. Communication between contractors, concessionaires and sureties is a crucial element in assuring that all associated contract terms and conditions are equitable.

PATRICK MOUGHAN
Vice President—Unit Manager, Surety Operations
Lockton Companies LLC

Managing growth is really what separates the premier contractors from those that fall short. Work is plentiful, and the temptation to pick up as much work as possible right now is great.

As brokers, we advise our contractor clients of the levels of capitalization that have historically supported work programs they undertake. We also examine contract
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terms and make certain our clients are avoiding onerous terms and clauses (unreason- able schedule, excessive liquidated dam- ages, consequential/actual damages, etc.) that put them at a great disadvantage before the project has begun.

Subcontractor exposure is a key element in managing growth. How our general contractor clients manage this risk can often be the deciding factor in the profit- ability of a single job, or an entire fiscal year. We are seeing many subcontractors “full up” with work; their labor force and management abilities are being stretched, and the ability for general contractors to spread subcontractor risk and vigorously prequalify their subs is vital.

Brokers and underwriters can certainly tell the stories from boom times past and present and offer sound advice to contractors, but at the end of the day the cream will rise, and the best contractors will con- tinue to judiciously use their resources to grow profitably.

HENRY W. NOZKO JR.
President
ACSTAR Insurance Co.
In a growth market, the danger for the project owner is getting into a contractual rela- tionship with a contractor who is unable to complete its job. The danger to the contractor is the same that has always been there—human resources and capital—the capability of project management and esti- mating projects. When a contractor is busy and running thin on management, that’s where mistakes happen in the field. If the estimating staff is running thin and multi- ple projects are being estimated, there may not be enough time to give careful review.

Backlogs should not be more than 10 times the company’s tangible equity. Revenue should not exceed more than $1.5 million per employee. Debt to equity should not exceed three to one. The average tenure of employees should be five years or more. The company should have profitable operations and audited financial statements. These are key items we look at, and many other sureties have similar views.

DAVID C. MOYLAN
Managing Director, International Surety Practice Leader, Global Construction Practice
Marsh USA Inc.
Current market conditions are more com- petitive than a year ago, depending on the capacity required. Surety companies are competing more intensely for financially strong mid-size contractors (work pro- grams under $250 million). Competition for large capacity or co-surety programs is less prevalent, as there are a smaller number of surety companies engaged in this busi- ness.

The industry was very profitable in 2006, and we expect 2007 and 2008 to be profitable as well. After that, the surety industry results will depend on the level of new construction (both residential and nonresidential), which was down quite a bit in the first quarter of 2007. We don’t expect any significant changes in under- writing for large capacity contractors. Any new capacity into the market will most likely focus on the small to mid-size con- tractor segment, and we expect underwrit- ing and pricing to soften for these contrac- tors.

FRANK RISALVATO
President
IRES Inc.
As 76 million baby boomers plan to retire, the nation is bracing for a mass exodus in the U.S. work force. As an executive recruiter specializing in the surety, claims consulting and forensic engineering industries, we have a unique vantage point over the sure- ty industry and how these departures may affect it.

We anticipate that the surety industry may experience more consolidation as companies compete to replace their retir- ing workforce. Those companies that are more aggressive and flexible in hiring will continue to grow. We’re seeing a clear dif- ference in hiring practices by sureties.

Those sureties that are proactive in their hiring practices, meaning they are recep- tive to referrals regardless of whether they have an opening, have an advantage over those companies that wait for a position to open before recruiting replacements. These companies are on the cutting edge of keeping fully staffed so they can better serve their clients.

Bond Producers Point to Promising Future

By Marc Ramsey, Surety Information Office (SIO)

The surety marketplace is “gearing up for a promising future,” according to a new survey published in March 2007 by Grant Thornton LLP.

The global accounting, tax and business advisory organization sur-veyed members of the National Association of Surety Bond Produc- ers (NASBP) in its “2007 Surety Credit Survey for Construction Con- tractors: The Bond Producer’s Perspective.” This year’s survey reveals insights and optimism from the nation’s leading bond agents, as well as striking differences from Grant Thornton’s last survey of NASBP members in 2005.

SURETY MARKET OVERVIEW

Citing the growth of the construction market in 2006 and the surety industry’s recovery from recent record losses, Grant Thornton asks, “Is it any surprise that the surveyed surety bond producers are optim- istic?”

The survey reports nearly a third of bond producers have a positive outlook for the construction industry, an improvement over the 21% who considered the market to be “on the upswing” in the 2005 report.

“Surety bond producers’ renewed economic optimism combined with their projected increased demand for bonds in the booming con- struction marketplace depict a favorable future for both sureties and construction contractors,” says Tom Novosel, national managing part- ner, Construction, Real Estate & Hospitality Industry Practice, Grant Thornton LLP.

Ease of obtaining surety credit (construction clients)

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<thead>
<tr>
<th>Term</th>
<th>Ease of Obtaining Surety Credit (%)</th>
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<tr>
<td>A year ago</td>
<td>Easy: 16% Difficult: 43%</td>
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<tr>
<td>Today</td>
<td>Easy: 26% Difficult: 26%</td>
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<tr>
<td>A year from now</td>
<td>Easy: 21% Difficult: 37%</td>
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S 12 www.enr.construction.com/resources/special/  June 18, 2007
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OBTAINING SURETY CREDIT

Todd Taggart, partner, Grant Thornton LLP, served on the team that developed the surety survey with NASBP and interpreted the results. “Overall, we see a very positive result from producers about the future and key elements that the surety looks at when construction contractors try to obtain credit,” Taggart says.

The commercial segment is very strong, he notes, and while surety credit is not easy to come by, it is easier than just a couple of years ago. Surety underwriters have consolidated and the industry has stabilized, and those results are reflected in this survey.

About a fourth of bond producers say obtaining surety credit is easy, while another fourth say it is difficult. “While this may not appear at first to be an optimistic assessment, it’s a far better situation than was reported two years ago,” the survey says. “In the 2005 study, half of the bond producers found it difficult to obtain surety credit for their clients and only 12% found it easy.”

In comparing the results of the 2007 survey with those from 2005 and 1996, Taggart notes how drastically the surety industry has changed.

“In 1996, surety was a loose market. It was easy to obtain surety credit,” he explains. “For example, only three-fourths of surety bond producers surveyed in 1996 thought a contractor’s equity was as important as other criteria such as strength of balance sheet and financial statement presentation for obtaining surety credit. By 2005, 92% of surety bond producers thought equity was important. In 2007, survey results reflect some softening, as 87% of producers rank equity among the most important criteria in obtaining surety credit.”

CONTRACTOR FAILURE

Another positive sign is revealed in the survey: only 8.5% of bond producers say contractors in their area appear to be experiencing unusual financial hardship, down from 14.6% in 2005.

The most frequently cited reasons for contractor difficulties, respondents say, are slow collections (45%), low profit margins (44%) and insufficient capital/excessive debt (44%).

“These were the same reasons topping the list in 2005 and have plagued the industry for years,” the survey says. “An interesting trend appears to be developing: More than four in 10 (44%) bond producers cite mismanagement of the business as a reason for contractors’ financial distress, up from 35% who saw this as a problem in 2005, and 28% in 1996.”

The survey continues, “Paired with an upswing in the perception of imprudent risk taking (37% citing this reason, up from 29%), weak project execution (29%, up from 21%) and poor estimating (28%, up from 21%) as major causes of financial difficulties, these findings suggest that unsophisticated management may be at the root of these contractors’ financial problems.”

SECURING BONDS

The strong construction environment, Taggart notes, is responsible for the decline in bond producers’ ranking of the importance of communicating potential problems early (from 82% in 2005 to 77% in 2007). “Contractors are having fewer problems because the market is up,” he explains.

Novosel adds, “Construction companies must continue to pay strict attention to their company’s financial well being and operating performance to ensure their ability to attain bonding will remain viable now and in the future.”

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<th>Major causes of financial difficulties among contractors*</th>
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<td><strong>2007</strong></td>
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<td>Slow collections</td>
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<td>Low profit margins</td>
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<td>Insufficient capital/excessive debt</td>
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<td>Mismanaging the business</td>
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<td>Inadequate controls</td>
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<td>Imprudent risk taking</td>
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<td>Onerous contract terms and conditions</td>
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<td>Weak project execution</td>
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<td>Poor estimating</td>
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<td>High overhead</td>
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<td>Inadequate volume</td>
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<td>Change order volume</td>
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<td>Lack of available insurance coverage</td>
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<td>High insurance premiums</td>
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*Percent of bond producers indicating each as a major cause of financial difficulty.
FUTURE OUTLOOK
About 40% of bond producers anticipate demand for bonds to increase in the next three years. "This outlook may be attributable to the expectation of continued strong government spending and an increase in demand for bonds for private sector work," the survey reports. "It is likely that owners are realizing the benefits of requiring surety bonds for private projects," the survey continues. "Not only does surety bonding confirm both the contractor's credibility and ability to complete the job, bonding may also provide a competitive edge when it comes to acquiring new jobs."

BREAKING UP PROJECTS
Many sureties prefer to spread their risk by having project owners break up a large megaproject into multiple large projects (to the extent they can be broken up), notes Mike Cusack, senior vice president, managing director and operations board member, Aon Construction Services Group. "Sureties want multiple contractors on multiple projects," he explains. "If the logistics of a megaproject prevent breaking the job into multiple large projects, the surety industry will require joint venture participation of well-qualified and well-capitalized construction companies."

Terry Cavanaugh, chief operating officer, Chubb Surety, adds, "A benefit to breaking a large project up into smaller contracts is increased competition. Smaller contracts attract more contractors who have the capability to bid on the project." Cavanaugh notes that as project size increases, so do the inherent risks on a contractor's financial resources, personnel and experience level.

Rick Kinnaird, chair, The Surety & Fidelity Association of America (SFAA), and senior executive, Surety, Westfield Group, cites other advantages to breaking up contracts. "Smaller contracts bring more opportunities for small and emerging contractors," he says. "Bundling of contracts limits competition, increases pricing and prevents contractors from being able to progressively grow in their construction expertise. You grow through experience. A contractor can't go from a $5-million project to a $100-million project."

Other options, Kinnaird suggests, include unbundling, phased contracting, multi-primes, and percentage bonds. He notes that partial bonds were used on the $1-billion+ Croton Water Treatment Plant and the $1.1-billion Miami-Dade County Airport Authority North Terminal Project, and are being proposed for the Fort Belvoir redevelopment.

ABOUT THE SURVEY
Grant Thornton surveyed NASBP members between December 11, 2006, and January 9, 2007, and 257 completed surveys were submitted with a margin of error of 6.1%. A PDF of the full report can be downloaded at www.gt.com/surety.

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CAPACITY
There is surety capacity available for qualified contractors. "If the characteristics of one particular engagement were ideal with a well-capitalized owner, fair contract, extremely strong and well-managed construction company and prudent subcontractor risk transfer," Aon's Cusack maintains, "the largest bond that any one contractor could secure from its surety company would be in the range of $500 million."

For joint ventures, Chubb's Cavanaugh says, "There is capacity up to $1 billion for the right job and right consortium. There are fewer sureties in play, but those sureties have brought a little more capacity to the table. Projects in this market segment present a wide range of risks—contractual, duration, funding, capital and organizational—and therefore demand underwriting experience and discipline."

KEEPING PROJECTS INTACT
Terry Lukow, executive vice president, Travelers Bond, Construction Services, says, "Some owners are procuring work in large blocks, because they want the best contractors to be doing the work. It was unheard of 10 years ago to have a $1-billion project. But there are more $500 million+ projects in today's marketplace than I've ever seen in my career. There are projects where it makes sense to break them into smaller projects. There are some projects that do not lend themselves to being broken up. The owners drive those decisions. They decide how they're going to procure the work."

Lukow concludes, "Most owners, especially in the private sector, have not invested in their ability to manage construction projects. Breaking a $500-million project up into multiple projects would require multiple teams of internal management, which they don't have."

Tom Kunkel, president and CEO, Travelers Bond, adds, "Owners can put more construction in place. Compare the administrative expense for the owner to manage one $500-million project versus the administrative expense to manage 20 different $25-million projects."

Sarah Finn, president, National Association of Surety Bond Producers (NASBP) and national surety vice president, IMA of Colorado, agrees: "It is easier for the owner to manage one project and they would rather deal with one contractor or joint venture. But that limits competition."

SPREADING RISK
"Joint ventures and co-surety arrangements are more prevalent because of underwriting standards, and this is not a bad thing. The
owner brings more resources to the table. For the contractor and surety, the arrangement mitigates their exposure. It’s win-win-win for the contractor, owner, and surety,” says Henry W. Nozko Jr., president, ACSTAR Insurance Co.

Bill Marino, chairman and CEO, Allied North America, says some sureties have responded by using reduced penalty bonds in certain situations where contract values are extremely large. “The formation of joint ventures to pursue these mega-project-opportunities has become commonplace given the tremendous quality of both technical and financial resources required to execute on these projects,” he says. “From the perspective of the owner, joint ventures and the corresponding co-surety structure necessary to support the larger bond penal sums are beneficial. There is a joint and several contractual relationship that exists between the contractors and the owner, as well as a joint and several relationship that exists between the co-sureties and the owner. In the event that one of the joint venture’s contracting entities fails, it becomes the responsibility of their partners to assume their contractual responsibility. Similarly, in the event that one on the co-sureties is not capable of meeting their obligations under the bond, it becomes the responsibility of the remaining sureties to assume their exposure.”

Sureties call for joint ventures and co-surety arrangements for several reasons. Some reasons, suggests Bill Cheatham, president, Zurich North America Surety, are to transfer risk, reduce risk exposure, when they are looking for specific skills or expertise, multiple takeoffs on a project because they want multiple opinions and when they want adequate capital support from the contractor side for the particular project. “Project owners are depending on the surety to manage a lot more than ever,” he says. “They are looking to the surety to do prequalification, and a strong joint venture strengthens the delivery of the project to the owner.”

Tim Mikolajewski, senior vice president, Safeco Surety, contends, “Spreading the risk out among several sureties is prudent capital management. If there was a problem on a megaproject, all the sureties involved could deal with the problem and still remain a competitive viable surety going forward. If one surety took on all that liability solo and a problem developed, it would likely knock them out of the surety market. The basic concept is to spread the risk among several contractors or sureties, so the failure of one partner does not put the entire project at risk. This is clearly a significant benefit to the owner.”

PROTECTION OF A SURETY BOND

Zurich’s Cheatham warns, “Contractors are attracted to a megaproject because it reduces competition, and I think some of those could potentially overextend their organizations. Contractors have only so many people who can run large or mega projects.”

Owners can offset some of that risk with surety bonds. “Underwriters bring claims knowledge and experience, dispute resolution experience, an understanding of contract terms and conditions and management of capacity,” Cheatham advises. “Surety companies provide a consultant perspective in operating a construction company based on its very broad experience. We manage over 4,000 contractors. Think of the expertise we bring at the middle and large size. We can help contractors grow from the knowledge we bring.”

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Performance Bond Claims: What an Owner Needs to Know

By Marilyn Klinger, Sedgwick Detert Moran & Arnold LLP

Owners obtain performance bonds to assure that the contractor will complete the contract for the agreed-upon consideration and in the agreed-upon time. In most cases, the owner procures the bond, files it away, and never sees it again. However, when the owner terminates the contractor and turns to the bonding company, the owner should be aware of the bonding company’s perspective to fully understand the process and the bonding company’s response.

This awareness of the process should incentivize project owners to begin communicating with the bonding companies as soon as problems arise on a project, not to begin the claims process as an adversarial relationship, but to give the bonding company as much information as early as possible in order to expedite the bonding company’s investigation should termination become necessary from the owner’s point of view.

INVESTIGATION

What frustrates owners most is the amount of time it sometimes takes for a bonding company to advise the owner whether it will complete the project. Owners may not realize that it is incumbent upon the bonding company to investigate the default termination and the project status to decide whether to complete the project and, if so, in what manner.

Surety is guaranty, which means the bonding company is obliged to answer for the default of the contractor. Thus, the bonding company owes a duty to the owner as long as there is a contractor default, as long as the termination was proper. Because the bonding company is the contractor’s guarantor, if the contractor does not owe an obligation to the owner because the owner wrongfully terminated the contract, then neither does the bonding company. The AIA Document A312 Performance Bond requires a proper default: “Whenever Contractor shall be, and declared by Owner to be in default under the Contract, the Owner having performed Owner’s obligations thereunder, the Surety may....”

In addition, bonding companies rely heavily on the indemnity (right of reimbursement) from the contractor if the bonding company suffers a loss as a result of having issued a performance bond. Contrary to what owners may believe, premiums are inadequate to protect bonding companies from the risks they undertake. Therefore, added protection comes in the form of indemnity from the contractor. However, that indemnity could be jeopardized if the bonding company completed a project where it had no obligation to do so.

In those situations, the contractor would argue that the bonding
company was a volunteer, without any obligation to incur completion costs. A volunteer typically is not entitled to indemnity or reimbursement. Hence, the bonding company would lose its right to recover against the contractor.

There are a number of ways a bonding company can meet its performance bond obligations including taking over a project with a completion contractor or through the existing subcontractors, tendering a completion contractor, or reimbursing the owner for excess completion costs. The bonding company’s decision is based, in part, on the status of the project including the percentage complete and the nature of the construction remaining.

If the project is substantially along, the better option may be to have the existing subcontractors complete the project under the supervision of a construction manager or have the owner use another of its on-site contractors to complete rather than finding a completion contractor.

In addition, there may be factors that the bonding company needs to know in determining the parameters of its completion and its negotiations with the owner. For example, the owner may be asserting defective construction while the contractor is asserting defective design. That dispute may affect the bonding company’s decision on its completion strategy or the type of completion contractor to retain.

DEFENSES
The bonding company is entitled to assert all of the contractor’s defenses including wrongful termination. Other defenses that the bonding company may assert include:

1. Failure to pay. Although a failure to pay could be a total defense, it also could be simply a point of discussion by which the bonding company and the owner agree to the amount of the contract balance remaining.
2. Defective plans and specifications. In conjunction with bonding company completion, it and the owner may agree to a mechanism by which the owner’s design professional works with the bonding company’s consultant to correct any defective plans and specifications.
3. Impossibility of performance. Similarly, in conjunction with the bonding company’s completion, it and the owner, working with the owner’s design professional, may revise the plans and specifications with appropriate adjustment to the contract price to respond to any issues of impossibility.
4. Failure to properly administer the construction contract (including late response to RFIs and proposed COs). Once again, the process of negotiating the bonding company’s completion of the project may include agreed-upon improvements in project administration or a change in owner, design professional, and/or construction management personnel.

THE SURETY’S OPTIONS
The AIA A312 form sets out the bonding company’s options. Even without an AIA A312 form, the options that have developed over the years for
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responding to performance bond demands are substantially the same.

WITHDRAWAL OF TERMINATION WITH CONTRACTOR COMPLETION

“Arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract”—Under this option, the bonding company, the owner, and the contractor negotiate an arrangement by which the contractor goes back on the job.

TAKEOVER

“Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors”—Under this option, the bonding company takes over the project, typically through a completion contractor, entering into a separate takeover agreement with the owner. The takeover agreement includes an agreement to pay the contract balance, a defined scope of the work, and the time for completion. Also, the bonding company will cap its liability to the bond amount, that is, limit its commitment to the total of the remaining contract balance plus the bond amount. The bonding company also will enter into a separate completion contract with a completion contractor to perform the work.

There are also situations where a bonding company will take over the project by employing the original contractor’s subcontractors plus a construction manager or consultant.

TENDER

The AIA A312 Performance Bond form contemplates a tender, although the concept has been an option that bonding companies used for many years.

“Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and the contractor selected with the Owner’s concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages … in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor’s default”—A tender agreement is similar to a takeover agreement except that the contracting parties are the owner and the completion contractor. Often, a three-way agreement is reached under which the completion contractor agrees to a price and the bonding company pays the amount that the new contract price exceeds the contract balance. Included with the completion contract will be new performance and payment bonds. The owner then will release the bonding company, although it may reserve its rights arising out of latent defects.

FINANCING

In the event that the contractor is having financial difficulties, the bonding company may finance the contractor’s completion. By financing, the bonding company may avoid default termination. The benefits to financing pre-default are that the work continues. Even after default, the bonding company can prop up the contractor and then use the contractor to complete the project, either by negotiating its return to the project or by using the contractor as its completion contractor in a takeover scenario.

OWNER COMPLETION

The AIA A312 Performance Bond form provides that the bonding company may “Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:

After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, tender payment therefor to the Owner.”

Thus, the bonding company can perform under its performance bond by paying money as opposed to completing. This option has generally been available to bonding companies throughout the history of construction surety bonds. However, all things being equal, a bonding company will typically choose to complete rather than have the owner complete in order to control completion costs and limit construction to the scope of the contract.

Marilyn Klinger heads the Los Angeles Construction Practices Group for Sedgwick Detert Moran & Arnold LLP, in Los Angeles, CA. She can be reached at (213) 615-8038 or marilyn.klinger@sdma.com.

SFAA MODEL CONTRACTOR DEVELOPMENT PROGRAM GAINS MOMENTUM

By Sam Carradine, The Surety & Fidelity Assn. of America (SFAA)

It all began at a luncheon meeting in suburban Maryland more than seven years ago. At that meeting was a Surety & Fidelity Association of America (SFAA) consultant who had most recently served as the director of a national minority contractors association, a senior underwriter with what is now the largest surety company in the country, and a bond producer with the second largest broker/agency.

Each of these individuals is African-American and each was particularly interested in exploring ways in which the surety industry could better address the issue of access to bonding for small and minority contractors.

In the past, efforts had been undertaken by some surety companies to target emerging contractors and the federal government had become involved, most notably through the Small Business Administration’s Surety Bond Guarantee Program. However, there was no industry-wide initiative that focused on assisting contractors in becoming “bond-ready.”

The luncheon meeting led to the drafting of a concept paper which, in turn, led to a request to the Board of SFAA to establish such a program. In May 2000, SFAA introduced the Model Contractor Development Program (MCDP) at its annual meeting. An adaptation of the best practices and efforts that had been undertaken by various local surety associations around the country, this initial version

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of the MCDP consisted of four workshops and a referral component to steer the contractors to whatever technical assistance they might need.

Since its inception, the MCDP has provided education about surety bonds; identified resources available for obtaining a first bond; provided assistance and referrals for obtaining appropriate accounting, project management and financing expertise; and directly assisted a number of small contractors in achieving bond readiness. More recently, the program has grown far more robust and now consists of eight comprehensive workshops on topics including construction accounting, bonding and insurance, estimating and bidding. The program also features a bond readiness component consisting of a review of bonding prequalification requirements, an assessment of contractor capability and capacity and the development of tailored strategies for reaching bondability.

At the SFAA annual meeting in 2006, then-Chair Gary Dunbar, bond division president, Great American Insurance Co., challenged SFAA-member companies to “elevate the issue of bonding disadvantaged contractors to a top-level initiative of our entire industry.” Through SFAA and the MCDP, these member companies have risen to that challenge.

In many instances, SFAA-member assistance has been through formal Memoranda of Understanding (MOUs) with various governmental entities and organizations. These MOUs have spelled out the areas of support sought from SFAA and the surety industry. Current MOU initiatives include partnerships with the U.S. Dept. of Commerce, Minority Business Development Agency (MBDA) and the MBDA Chicago Regional Office; National Veterans Business Development Corp.; Economic Development Corporation of Prince George’s County, MD; Suffolk County, NY; City of New Orleans; Indianapolis Black Chamber of Commerce; Mississippi Development Authority, Office of Small and Minority Business Development; and Massachusetts Alliance for Small Contractors.

In other instances, SFAA members and staff have provided direct assistance and support, though no formal agreement has been in place. Some of these other initiatives include ongoing assistance to the State of Ohio Bond Guaranty Program; State of New Jersey including Essex County Office of Small Business Development & Economic Opportunity; and Hillsborough County, FL. For all of these initiatives, the objectives have been the same—to use the resources of SFAA and the MCDP to assist emerging contractors in increasing their access to bonding.

For more information on the Model Contractor Development Program, contact Sam Carradine at (202) 778-3638 or scarradine@surety.org.

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SURETY MARKET RESOURCES

SIO: THE INFORMATION SOURCE FOR CONTRACT SURETY BONDS

The Surety Information Office (SIO) is the information source for contract surety bonds in public and private construction. SIO provides free brochures, CDs and PowerPoint® presentations about surety bonding to construction project owners, lenders, contractors and design professionals. These informative materials, which can be viewed, ordered or downloaded via the SIO Web site at www.sio.org include:

- Contract Surety Bonds: Protecting Your Investment
- Why Do Contractors Fail?
- Importance of Surety Bonds in Construction
- Surety Companies: What They Are and How to Find Out About Them
- An Overview of the Contract Surety Bonds Claims Process (AGC)
- Surety Bonds: A Guide for Private Owners (CD)
- Surety Bonds: A Guide for Public Construction (CD)
- Surety Bonds: A Guide for Contractors (CD)
- Surety Bonds: A Guide for Students (CD)

SIO can help you locate an NASBP-member producer, find a professional to speak about surety at your conference or meeting and answer your questions about contract surety bonding. Contact Marla McIntyre, executive director, at (202) 686-7463 or mmcintyre@sio.org.
SURETY MARKET ASSOCIATIONS

The Surety Information Office (SIO) is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles and answer questions on contract surety bonds. SIO is supported by The Surety & Fidelity Association of America (SFAA) and the National Association of Surety Bond Producers (NASBP). All materials may be accessed at www.sio.org.

The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state and local government agencies.

The National Association of Surety Bond Producers (NASBP) is the association of and resource for surety bond producers. NASBP members are professionals who specialize in providing surety bonds for construction and other commercial purposes to companies and individuals needing the assurance offered by surety bonds. NASBP members have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.

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