

# What Does Your Bonding Company Think?

By William F. Maxwell and Joel H. Miles  
The Fails Management Institute

**H**ave contractors adequately planned for their business to continue in the event of their death? The surety industry doesn't think so. The Fails Management Institute (FMI) recently performed a survey of the contractor surety industry relating to business continuity and management succession planning. The respondents stated that 50% of their contractor clients plan adequately for the continuation of their business in the event of their death. That's the good news. The bad news is that the other 50% have an inadequate plan or no plan at all.

Bonding companies have been putting more pressure on firms to develop and implement continuity plans. The surety respondents stated that they have required 14% of their contractor clientele to put a continuity plan in place in order to receive bonding. Sureties also stated that 35% of their contractor clientele need to develop such a plan. The reasoning behind this is partially due to the age of a large percentage of owners of contracting firms. Many successful construction firms started after World War II. The calendar is catching up with these owners, and significant changes in ownership will occur within the next 10 years.

Given this fact, and the mood of the surety industry, we expect increased importance to be placed upon business continuity planning in order to receive bonding support. Approximately 4% of the surety clients have been refused bonding because of a lack of adequate business continuity planning. This drastic action may become more prevalent.

Here are some other interesting facts that were revealed in this survey.

— Almost all owners would like to have their business continue upon their

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departure, but only half succeed. What prevents them from being successful?

— Seventy-three percent of the surety respondents identified the primary reason why contracting firms cannot continue is due to management succession problems. Finding and developing successor management is one of the most difficult tasks an owner faces. An

owner must help the next generation develop the skills necessary to run a construction company. Unfortunately, this training and development requires a set of skills not usually possessed by the founder of the firm.

— Of continuity plans deemed unacceptable by surety companies, almost one-half fell into this category because the plan called for a reduction in the equity base of the firm. A construction company must maintain an adequate level of equity relative to its revenue in order to receive bond credit. Most construction companies are not over capitalized, and any significant reduction in their equity base will cause their bonding limits to be reduced.

**Are Personal Guarantees  
A Cost of Doing Business?**

One might assume this is true since 92% of all contractors provide personal guarantees for bond credit. Presumably contractors who do not sign personal guarantees are very well capitalized relative to their work program.

Close to 22% of the contractors have sold all of their stock and still remain on the personal guarantee. This is sometimes done in family situations.

The average amount of stock minority shareholders must own before

they are required to personally guarantee bonds is 14%. Potential shareholders should be alerted to the likelihood that if they become significant shareholders, a personal guarantee will be required. The issue of personal guarantees can be a major impediment in the continuity planning process. New shareholders will be leery of signing the guarantees, and the older shareholder may be required to continue the personal guarantee until the successor management is proven. The only way to avoid this problem is to begin the planning process early to build the equity base of the company.

#### **How Do Owners Cash Out of the Business?**

At some point in time the owner will get out of the business. This can be done in a number of ways. The survey indicated that 70% of construction companies are sold or gifted in some form to the owners' children or employ-

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*... bonding companies are putting more emphasis on business continuity and management succession planning for contractors, [but] only 50% of the contractors have an effective continuity plan in place. Are you one of the contractors without one?*

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ees. This indicates that most owners have an innate desire to keep the business in the "family." Only 20% of construction companies are liquidated. Many owners view their business as part of the family and have a hard time liquidating it, even if it is the most economical solution

Construction companies are merged or sold to an outside company in 10% of the cases. The small percentage sold or merged reflects the limited acquisition market for construction firms. ESOPs, while continuing to gather a lot of press, are still used infrequently in the construction industry. ESOPs are best used in companies that have steady or increasing earnings and are managed democratically. This description fits only a small percentage of construction companies.

A buy-sell agreement is used when more than one person owns shares in a company. The buy-sell agreement usually contains provisions pertaining to the terms, conditions, and any triggering events for a buy-out of a

shareholder. Approximately 57% of contractors have a buy-sell agreement in place when there is more than one shareholder. This number should be 100%! Shares should never be distributed to more than one person without a buy-sell agreement. Such an agreement protects all parties and avoids disputes in the future.

#### **How Important Is Life Insurance?**

Life insurance has two functions in continuity planning. One is to protect the estate by providing a funding mechanism for the purchase of the deceased owner's stock. The second is to protect the surety's position by injecting cash into the company to help offset the loss of the key person. Eighty-three percent of the contractors are required to have life insurance by the sureties. Presumably the remaining 17% are in such a financial position that it is not required, or have some other funding mechanism in place.

Of the contractors who have life insurance, 78% of the insurance is owned by the corporation. Because of the Alternative Minimum Tax, which could tax corporate proceeds at 20%, tax planners suggest that life insurance be held outside of the company. The life insurance is still held by the corporation for a couple of reasons; it is easier, and it provides better access to the funds by the surety.

#### **So...What Does Your Bonding Company Think?**

As the results of the survey indicate, bonding companies are putting more emphasis on business continuity and management succession planning for contractors. Effective plans protect the owner, owner's family, employees, and sureties. However, only 50% of the contractors have an effective continuity plan in place. Are you one of the contractors without one?

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#### **About The Authors:**

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