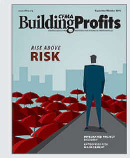

BY THOMAS L. JOLLAY & DOUGLAS L. RIEDER

Surety Considerations for Succession Planning in Construction

Succession planning isn't just a road map for ownership transition. Today, failure to develop a succession plan can cost a construction company a contract if the bond for a prospective project is denied because succession has not been addressed.

In a typical two-party insurance relationship, the client (insured) pays a premium for a policy that transfers their risk to the insurer. But when issuing a performance bond, the insurance arrangement involves three parties: the surety (generally an insurance company), the principal (contractor), and the obligee (the project owner).

The ultimate risk for the surety occurs if the principal (contractor) is unable to complete the contracted responsibilities. The surety must then engage a replacement contractor to fulfill the contract, thus incurring the loss. This loss is exacerbated because the project must be completed in a defined period of time, and the costs to complete the remaining percentage of the job will be significantly higher.

Accordingly, a surety has a vested interest in anything that could increase the risk of a contractor not being able to fulfill its contractual obligations – including succession planning.

Overcoming Succession Planning Fears – A Critical Step

Even though most construction owners understand why they should develop a succession plan, taking steps to do so remains one of their greatest challenges. After all, succession planning requires owners to address two uncomfortable truths: dealing with their own mortality and giving up their business.

Since most owners spend more time at work during their lifetimes than anywhere else, there is a fear of the unknown about letting go of the familiar and giving up what they have created.

(For more on this topic, refer to "'But They'll Never Retire' – Overcoming Management Succession Procrastination" by Michael Mangum & Jake Appelman in the May/June 2015 issue.)

Owners should consider at least two factors to help them overcome inaction. First, the business could realize the surety's impact at the least opportune time (read about an example on the next page) and lose an important, multiyear contract. Secondly, owners should consider the impact their demise could have on relationships with customers, suppliers, employees, and employees' families because surety underwriters have certainly considered it.

A surety's guarantees can easily represent millions of dollars per project and hundreds of millions to even billions in aggregate. From the surety's perspective, a contractor must, at a minimum, establish continuity agreements that provide financial incentives for key management personnel to remain in place at least until the contracts in progress are completed.

Beware of Unexpected Hardships

In addition to economic and business-related issues, other situations can derail a contractor from being able to perform its responsibilities, especially if its leaders – typically owners – are adversely affected. At any time during the life of a contracting business, the leadership can be impacted by:

- Disability of an owner, which may reduce his/her ability to provide the needed leadership.
- Divorce, which may create a financial burden.
- Personal financial hardship or bankruptcy of an owner.
- Death of an owner.

While owners may not often think about these issues, especially when they are younger and their business is performing well, it's important to realize that sureties are educating their agents about the exposures and encouraging frank discussions with their contractor clients.

With many risks to consider, the demand from sureties for clearly defined solutions in advance is on the rise. Sureties have a vested interest to ensure their clients have succession plans in place or at least inject significant liquidity to retain the necessary staff to facilitate a smooth business transition.

What Should Contractors Expect?

Because the surety has a heightened interest in preemptive resolutions, don't be surprised by seemingly probing questions. A surety's business model relies on a deep understanding of all proposed solutions and thorough consideration of the possible outcomes.

Equally, a surety is in business to foster long-term relationships with its clients. Contractors should understand what the surety is looking for and how to demonstrate that a thoughtful and comprehensive contingency plan is in place.

Sureties may request a host of underwriting data, including CPA-prepared financial statements, stockholder personal financial statements, copies of credit facilities, business plans, company and key leaders' résumés, confirmation of appropriate insurance coverages, and copies of any business continuity provisions the company may have in place.

For a contractor that specializes in smaller, quick-turning projects, a surety may only be concerned that there is a basic plan to keep key people on board until the work can be finished. This can be accomplished through simple management completion agreements tied to performance bonuses (funded by life insurance or the equity capital of the business). However, larger, more complicated and longer projects would demand a more robust, strategic approach.

Impact of Succession Planning on **Surety Bonding**

Consider this real-life example from a surety underwriter whose company had a long-standing, active relationship with a contractor owner-client. The client, who regularly landed road construction projects upwards of $50 million, had just been awarded a large three-year contract that required a surety bond.

Much to the client's dismay and after a decades-long professional relationship, the underwriter was forced to terminate the relationship, revealing that the surety could not issue the requisite bond. From the underwriter's perspective, the risks outweighed the rewards: The client was 73 years old, dealing with health issues and, most importantly, owned 100% of a company in which there was no succession plan in place.

Succession Planning Strategies Through the Underwriter's Eyes

For the contractor that wants to avoid hitting the wall, here are some of the options as seen through the lens of the surety.

Transfer/Sale to a Family Member

Passing a family-owned construction company to the next generation is common in the construction industry. From the surety's perspective, an intra-family transfer/sale only works if the family member has been actively involved in the business and the plan is well received by the employees and the contracting business community.

Also, the portion of the business that is treated as a sale will likely create debt for the owner, whether owed by the business or by the family member. The surety will evaluate whether the business can generate sufficient profits to service that debt as well as provide sufficient economic benefits to the new owner so that he or she isn't just working to pay it off.

Actuarial tables are based on statistics; according to the Family Business Alliance, only 30% of family businesses survive into the second generation, diminishing to about 12% still viable into the third generation. Nearly nine in 10 family business owners believe the same family or families will control their business in five years.[1] The onus may be on the owner to prove that the family can beat the odds.

Author's Note: This alternative involves a number of issues to consider that are beyond the scope of this article, including gifting and estate planning as well as the valuation of the business.

Sale to Management

There are several ways to accomplish a sale to management (including those who are already owners of some portion of the equity): buy-sell agreement; Oldco/Newco strategy; or employee stock ownership plan (ESOP).

Buy-Sell Agreement

The most common way equity is transferred to specific persons is through a buy-sell agreement. Such an agreement can be structured to trigger equity sales upon death (usually funded with life insurance), disability (usually not funded – so financing terms should be favorable to the survivor), or retirement. Buy-sell agreements typically prohibit sales of stock to anyone other than specified management, which keeps shares from going to inactive or incompetent shareholders.

In a cross-purchase plan, life insurance is purchased and payable to surviving shareholders to allow them to directly purchase the shares of the deceased shareholder. On the other hand, a stock redemption structure will require that the company be the beneficiary of the funding in order to redeem the shares corporately.

Normally, funds that come from life or disability insurance though debt (seller financing or bank debt) can be used. If debt is used, then long-term seller financing is usually best (if all can agree). If the purchases are not fully funded, then the surety generally will prefer longer-term seller financing so as not to overburden the company or purchasing shareholder. In some cases, it may make sense for these notes to be subordinated to the surety to allow it to be in senior position to this debt and help the capital structure.

Generally, all new work is contracted in the new entity. As capital accrues in the new company over time and it is able to stand on its own for bonding and banking, the old company should be able to distribute its capital, as less is needed.

Since a new entity must be established, licensed, and capitalized, significant administrative costs can be associated with this method. Also, the new company may need to use equipment and other assets of the old company, for which rent would be paid. Separate books must also be maintained and reported.

This method allows the transitioned management to begin running the new company with the safety net of the old company for a meaningful bridge period. To be successful, involve internal advisors (agent, CPA, attorneys, and bankers) early for collective input and agreement to the plan. If the new company underperforms, it can allow for flexibility by deferring or reducing payments to the old company and/or deferring the withdrawal of the old company's support.

Today, failure to develop a succession plan can cost a construction company a contract if the bond for a prospective project is denied because succession has not been addressed.

In addition to prescribing the financing, the valuation method should be specified and have a way to mediate the value if there is disagreement. Given that values may fluctuate, the agreement must be regularly revisited to ensure that funding, financing terms, and valuations are kept in sync with each other and changing economic conditions. It's critical for the surety to be involved in these terms, since a set of circumstances that is likely to foster disagreement among the parties means that management is less likely to be fully focused on continuing profitable execution of the contracts.

Oldco/Newco

This method is ideal for contractors to maintain significant capital in the business for bonding purposes. The strategy involves a strong existing company remaining in place alongside a newly created company whose ownership consists of the next generation, or a mix of the old and the new.

The better-capitalized sister company, upon a negotiated agreement with the surety, will maintain a certain level of agreed-upon capital to support the bonding of the new entity. Fees can be paid from the new company to the old company for this capital support and from the old company to the new for management and personnel used to complete the old work.

Sureties tend to favor this method, as it requires the team to be out in front of the issue and takes communication and partnership to be successful.

Employee Stock Ownership Plan

Many contractors have successfully implemented ESOPs with their sureties' support. However, in order to receive that support, the following concerns from the surety should be addressed:

- Significant administrative burden is incurred. ERISA compliance, audited financial statements, annual evaluation appraisals, fiduciary risk, cyclicality of construction, etc.
- Selling shareholders may not want to continue to indemnify the surety.
- Leverage required may hamper available bonding capacity.
- Shareholders will tend to have significant concentration of risk in an ESOP company.

ESOPs continue to gain popularity; however, their technical requirements, applications, and benefits are beyond the scope of this article.

Sale to a Third Party

In many industries, retiring owners have a very viable option of selling to a third party – whether the buyer is a competitor or perhaps a private equity group. For contractors, selling to a competitor may not be ideal; however, selling to a private equity group could be considered.

Driven largely by central bank policies, investment capital is ample and available, while returns are suppressed. In this environment, construction is in high demand by private equity group buyers. These solutions tend to have a large debt component, which may result in higher prices for the seller. The resulting leveraged capital structure tends to be a challenge for the surety industry.

Since sureties dislike inactive (and generally nonguaranteeing) shareholders and interest-bearing debt, these types of transactions are difficult for them. Also, many private equity investors don't have much experience in the construction sector. As such, the transactions are generally only done with such credit enhancements as:

- *Collateral* – Generally in the form of an Irrevocable Letter of Credit. Typically expensive (2-5% of the amount), an Irrevocable Letter of Credit requires that restricted cash balances be held with the provider. Also, the amount can be significant, representing anywhere from 10-40% of the bonded program.
- *Subordinated debt* – It may be possible to subordinate the junior or mezzanine debt to the surety to "carve out" some capital to be in front of the surety.
- *Third-party indemnity* – Partial guarantees from interested parties such as selling shareholders, remaining management/owners, the private equity group itself, or one of its funds.

All of these issues are challenging. If collateral is the solution, then the economics must be factored into the business plan or the deal can fall apart. Usually a combination of collateral and subordinated debt is part of a package; third-party indemnity, on the other hand, is very hard to obtain.

However, with favorable economic conditions and current low rates, private equity group deals are likely to continue for some time.

Summary

As Baby Boomers continue to retire, succession among construction company owners will increase. It's imperative to your company's immediate and long-term future.

So, start early, huddle with your industry advisors, develop a plan, and execute it. Include the surety as part of the advisory group so that the new owners have an operating construction company with adequate bonding capacity and a higher probability of a successful transition. ■

Endnote

1. *www.fbagr.org/index.php?option=com_content&view=article&id=117&Itemid=75.*

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