

# Legal Spotlight



## **Funds Administration: An Important Tool for Sureties and Contractors**

If a surety can control and mitigate its payment risk, the surety is more likely to issue bonds on behalf of a contractor. Funds administration, also referred to as funds control, funds disbursement, funds management, and escrow, is a method that sureties use to minimize the possibility of a claim against a payment bond. In addition to benefiting the surety, the use of funds administration on a project benefits the principal as well. The funds administration service on a project can mean that a contractor that would otherwise not qualify for a bond can pursue certain bonded projects and, at the same time, learn how to manage cash flow and project funds.

A surety will require funds administration on a construction project under certain circumstances, to try to eliminate the payment risk and to reduce the performance risk as well. Either a third party or the surety's funds administration subsidiary performs the service. Once the bonded contract is awarded, the tripartite funds administration/escrow service agreement is executed by the principal, the funds administrator, and the surety. Each funds administration agreement is unique, with the conditions set by the surety, based on its underwriting approach. A fee is usually associated with the use of a third-party administrator. The agreement provides that the funds administrator establish a separate bank account in the contractor's name, receive directly all the bonded contract proceeds from the owner, and disburse payment, as well as overhead and fees, during the course of the project.

Most funds administrators require the contractor to obtain a letter from the project owner, called a "letter of direction," to assure the owner's understanding that all progress payments on the project will be sent directly to the funds administrator. The funds administrator will receive a job cost breakdown prior to the commencement of the work. Upon receiving each progress payment, the funds administrator will typically draft checks payable to all subcontractors, suppliers, and other vendors and will forward them to the contractor for final review before the checks are distributed. In addition, a payment to the contractor for an agreed amount of profit and overhead will be distributed. After each draw, the funds administrator provides lien waivers and reports on the project to the surety.

Only incurred costs for a particular billing period and the agreed overhead and profit percentages will

be paid from each progress payment. The funds administrator performs its due diligence by reviewing the request and associated support to confirm that the requested payments are proper, reasonable, and project related. Upon project completion the contractor should have already been reimbursed all costs associated with the project as well as the profit and overhead and, in most instances, retainage. If additional funds remain in the account at the end of the project, they will be disbursed to the contractor when the surety signs off on closing the account.

Since most failed projects are caused by cash flow problems, mismanagement of project funds, and diversion of project funds to other projects, funds administration helps surety companies mitigate their risk on bonded projects. Funds administration also saves on claims expenses in the event of a loss by providing the surety with a record of progress reports.

Funds administration is one tool that can be used to enhance a small and emerging contractor's ability to obtain surety bonds by providing it with the financial assistance necessary to learn how to properly manage construction funds and cash flow on its projects. Through the use of funds control, small and emerging contractors can increase their bonding capacity and pursue contracts for which they would not ordinarily qualify for surety credit. In addition, a small construction firm can focus on performing the work while learning how to manage cash flow on the project. The use of funds administration might also allow a contractor to negotiate better credit terms or discounts from subcontractors and suppliers. It should be noted as well that lenders are often more willing to extend a contractor financial credit when funds administration services are used on a project, because the process ensures that the lender's loan proceeds are going only into the intended project.

The funds administration service essentially gives a surety comfort that all the funds paid to the principal on the bonded project will be used to pay vendors that supplied labor, materials, and equipment to that specific project, directly protecting the payment bond. By preparing and obtaining lien waivers to be signed by each party receiving the check, the funds administrator also helps protect the owner, the project, and the principal from liens and claims.

Bond producers and other surety professionals should let their contractors and subcontractors know that the use of funds control can benefit them by: (1) helping them to qualify for bonds or to increase their bonding capacity; (2) teaching them how to manage funds properly on a project; (3) using escrow to extend or enhance credit with vendors; and (4) ensuring lenders that the loan proceeds will go into the intended project.

In the next issue of *Pipeline*, the Legal Spotlight will focus on joint check agreements.

**May/June 2015 NASBP Pipeline e-newsletter**  
***Legal Spotlight—Funds Administration: An Important Tool for Sureties and Contractors***



*The author of this article is Martha Perkins, General Counsel at NASBP. Martha Perkins can be reached at [mp Perkins@nasbp.org](mailto:mp Perkins@nasbp.org) or (202) 686-3700.*

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