BY MATT HODSON

THE TRUTH ABOUT ESCROW: *The Good, the Bad & the Ugly*

In the wake of the most recent recession, contractors and sureties have had to find new ways to make good projects succeed and to remain part of an increasingly competitive food chain.

One particular underwriting tool that has grown in popularity is the use of an escrow account, often called funds control.

Although escrow has a mixed reputation in the contracting and surety communities, a well-informed contractor and an astute surety can use escrow to garner a more attractive bond program and find opportunities outside of their normal capacity.

While escrow can be beneficial, it is not a panacea of surety bond underwriting. A contractor that does not understand the process or properly vet an escrow agent may find an escrow agreement frustrating. (Refer to the sidebar on the last page for more on vetting an agent.) Likewise, a surety should not rely on escrow as a silver bullet in underwriting.

This article is intended to provide a better understanding of the escrow tool, how to use and manage it, the risks involved, and the role of an escrow agent.

How Is Escrow Used in Surety?

When underwriting a surety bond, an insurer may make an offer to a contractor that includes the use of funds control as a condition for providing a bond or bond program. This would require that the contractor enter into an agreement with the surety or an external service provider to provide a job-specific escrow account to manage all project funds.

Typically, an escrow account is governed by an additional agreement that defines the contractual relationship between the named escrow agent and the contractor. The agreement also specifies the terms and conditions for the disbursement of project funds by the escrow agent. These terms and conditions are generally comprised of what the surety community deems to be best practices for the proper management of project funds.

Regardless of who acts as agent, the agreement is typically a two-party agreement between the agent and the contractor, but is usually submissive to the surety's rights under its general indemnity agreement.

The escrow account captures all project funds, which are disbursed by the agent at the direction of the contractor upon an objective review to confirm that the terms of the agreement are being met as the project progresses. Provided the terms of the control agreement are being met, and the contractor has not run afoul of any terms of its general indemnity agreement, the account funds should flow without surety intervention or restrictions.

In general, there are three types of surety approaches to escrow and fees:

1) A surety may require the use of an independent escrow agent without any form of shared compensation.
2) A surety may use an in-house escrow facility as an accommodation for a portion of its business when needed.
3) A surety may specialize almost exclusively in internally managed escrow business, for which escrow fees are a profit center.

In the first scenario, the agent is not taking regular direction from the surety under normal circumstances, and is not affiliated with the surety. The account should be individually titled at a known bank, and the contractor should receive typical bank reporting, even though the agent controls the account.

In the second and third scenarios, the account is held and controlled by the surety and is typically handled by a specific department within the surety. The third scenario should be considered with more caution than the others. The surety that closely integrates escrow income with premium income may be less likely to provide bonding support without escrow, particularly when the contractor is entitled to it.

The Good

A Better Offer

When an escrow is part of a bond program, it is typically an integral part of an offer that may be more competitive in capacity and/or indemnity terms. By adding a mechanism for payment risk mitigation, a surety can afford to be more accommodating with the other terms of the offer.

Contractors may avoid choosing a bond offer with escrow out of fear of the process; however, a good surety agent can outline the pros and cons of multiple surety options to help the contractor make a well-advised decision.

New Frontiers

A contractor may find a surety more willing to bond a project that is out of its typical range (e.g., size, scope, or location) with the presence of an escrow account. Often, a contractor ventures into these areas because of a lack of opportunity in its normal market or the promise of a high reward.

An escrow tool can make bonding support for these types of projects more attractive to the surety. These types of projects are generally the first to challenge standard underwriting philosophy because they have historically produced a higher loss ratio for the surety industry. In this sense, using escrow as a risk mitigation tool can be the difference between a "no" and a "yes."

Partnership

An escrow tool can provide transparency among business partners and help reduce the skepticism inherent in a multiple-entity deal that puts the control of cash in the hands of one party over another.

Because the recovery of a potential loss can be complicated and more costly for entities or projects that involve complex ownership, partnership, or management structures, sureties tend to avoid them regardless of the quality of the project. An objective escrow account that serves as a place for the isolation and safekeeping of project funds can make these types of offers more acceptable for a surety and business partners alike.

Regardless of the project or ownership structure, the project funds are not distributed or available to entities or partners until they are earned.

Support Staff

With normal project volume resuming, many contractors have been slow to replenish key support staff. This may cause a disconnect between support staff and upper management.

An escrow agent can often bridge this gap by providing support and analysis on an as-needed basis. The escrow agent's relationship can also be added or terminated on a project-specific basis, making it easier for a contractor to keep that portion of its overhead aligned with actual production.

Objectivity

Contract payment disputes can be resolved with the presence of an objective party to witness, document, and analyze project payment information during the early stages of the dispute. This can be very productive, particularly when the contractor has a defensible position that the escrow agent can substantiate.

Often, the presence of an objective third-party escrow agent can promote transparency and integrity among all parties, including an owner that is slow to pay or a supplier that makes a claim for payment on material for unrelated projects.

An escrow agent can also provide assurance to a lower-tier party that it will be paid if a contract payment is past due. This transparency is vital to encourage a subcontractor or vendor to continue to furnish labor or material or discourage the filing of a claim or lien prematurely.

In addition to reducing the likelihood of payment disputes, an escrow agent can help a surety dismiss an unjustified claim through proper documentation, or can be critical to encouraging the contractor to satisfy a legitimate vendor claim before it reaches claim status. Resolving disputes before they become legal processes (and involve attorneys, claims, or liens) can help the contractor and surety keep costs down and production moving.

Credit

Better credit terms are frequently extended with the presence of a controlled escrow account, which can work to contractor's advantage in terms of vendor pricing.

By furnishing copies of the escrow agreement and bonding to a significant creditor, a contractor may capture a higher job margin through better leverage with vendors during the buyout stage of a project.

It is also common for a pivotal vendor to furnish material, relax payment terms, or forego a joint-check demand based on the presence of the escrow account.

Payment Efficiency

The most common misconception about escrow is that it will delay payment to vendors. However, an escrow agency should process payment within a couple of days, which can mean funds clear and vendors are paid more quickly than if the contractor had managed the funds itself. It also typically means a more consistent payment process regardless of the contractor's administrative workload.

An escrow agreement should provide clear terms and conditions regarding turnaround time. Realistic expectations should also be set with subcontractors and other vendors to allow ample time to deposit and render payments. With an escrow in place and a contractual obligee that pays consistently, the payment process for vendors is often improved rather than delayed.

The Bad

The Directive

If a surety makes a bond offer with an escrow condition, then it relies on the escrow to prevent loss in a worst-case scenario. Therefore, the contractual obligee, owner, or prime contractor must be a party to an agreement that funnels project payments into the escrow account, commonly referred to as a "letter of directive."

Many contractors are hesitant to approach an owner or prime contractor at the award stage of a project to request this document out of fear that they may be passed for the next bidder or that their image may be tarnished for future work, but this is another misconception.

Since the use of escrow at the underwriting stage has increased, most GCs have become familiar and agreeable to escrow terms. Some GCs even have their own directive templates. Because escrow is an effective mitigation tool for payment risk, it benefits everyone, including the owner and prime contractors.

Vetting the **Escrow Agent**

Prior to the contractor considering a bond program with an escrow agent involved, the contractor and its surety should properly vet the escrow agency. A qualified escrow agent should have a good record of prior work and a solid reputation among sureties and agents. The escrow agent should readily provide proof of proper insurances and strong references within the surety community.

The contractor must be willing to embrace the presence of a third party in its internal processes, and the project should have sufficient funds to cover the escrow fee.

Regardless, most contractors would likely want to avoid having to make requests of an awarding entity.

Workload

Unlike a normal operating account, a disbursement account requires time and resources to manage the process and communicate with the escrow agent. While a contractor might otherwise pay vendors as invoices become due, a properly managed disbursement account may require a contractor to complete an entire month's package at one time. This may increase workload or require a routine for documentation that differs from that of other projects that are not bonded or managed through the escrow.

Costs

While receiving funds and cutting checks can be simple, properly managing a disbursement account is more costly. The escrow process is labor-intensive, as the agent must employ proper internal controls, perform a thorough analysis, and report to both the contractor and the surety.

A difference in fee between escrow options should be considered based on quality, timeliness, and accuracy of service. A few dollars saved on escrow fees can prove very costly if jobsite issues arise due to lack of responsiveness or competence during the short time that the escrow agent should be holding the project funds. In any scenario, the cost of the escrow must be borne by one or more of the parties in the contract, and is in addition to bond premium.

The Ugly

Unforgiving

As is the case with any agreement, the contractor must read the fine print before executing an escrow agreement. A contractor that has agreed to an escrow arrangement in order to get a bond may be surprised when payments begin to flow on the job, particularly if that contractor has historically relied on the ability to move cash from project to project or pay overhead costs from project funds.

Since sureties consider the escrow arrangement to be a condition of providing a bond, they expect the contractor to honor the terms of the agreement after the bond has been provided; a contractor should not expect the process to become flexible or negotiable.

Misuse

Although the method of mingling funds from multiple projects in one operating account is common in the industry, it is also the source of the single biggest risk to a surety and is expressly prohibited in an escrow arrangement.

Escrow may prove to be a painful reality, and it could force some difficult conversations with the surety early in the job if the contractor signed the agreement without fully understanding its terms and conditions and/or made other commitments with the first overbilling or deposit on a project. Essentially, a proper escrow agreement is designed to prohibit robbing Peter to pay Paul.

Summary

The escrow tool is not a perfect fit for every contractor or every underwriting situation. It does not address performance issues, and it cannot make a bad project a good one.

In order to function effectively and efficiently, a successful escrow arrangement requires cooperation among all parties. A contractor must make an honest assessment before getting involved in an escrow arrangement and be willing to accept the resulting project cash flow restrictions. It is imperative that a contractor plans accordingly to avoid falling short on promises elsewhere.

A contractor that is familiar with the process can use an escrow tool to its advantage by garnering a better bond program.

A commitment to project-specific funds discipline on the part of the contractor typically leads to a more generous bond program, and in many cases can help a contractor tighten up its internal operational and cash management procedures. This can be a huge step toward better bond terms from a surety and can facilitate profitable growth for the company.

Overall, a properly managed escrow process can be rewarding and productive for all parties. ■

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