

**THE SURETY & FIDELITY ASSOCIATION
OF AMERICA**

Testimony of Sam Carradine

Before the Council of the District of Columbia

**Committee on Government Operations
and the Environment**



**Bill 18-610 – The Omnibus Procurement Reform
Amendment Act of 2010**

Bill 18-635 – The Procurement Reform Act of 2010

March 23, 2010

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Chairperson Cheh and members of the Committee, thank you for inviting us here today to testify on a matter that is critical to the surety industry, to the construction industry and to small and emerging businesses.

The Surety & Fidelity Association of America (SFAA) is a trade association of more than 450 insurance companies that are licensed to write surety and fidelity bonds. SFAA members collectively provide the vast majority of performance and payment bonds on federal and state construction projects in the United States.

Summary of the Surety Bonding Provisions in Bill 18-635

Bills 18-610 and 18-635 have been introduced in the Council of the District of Columbia to amend and rewrite the current procurement laws for the District (DC Code § 26-01 *et seq.*). While Bill 18-610 is silent on the issue, Bill 18-635 would increase the threshold for bid, payment and performance bonds for public construction contracts from \$100,000 to \$500,000. This provision is the subject of our testimony today. If enacted, this legislation would give the District of Columbia the highest bond threshold in the nation and one that is far higher than the level at which the federal government protects itself and federal taxpayers.

Why States and the Federal Government Require Payment and Performance Bonds on Public Works

There is good public policy for the requirement of performance bonds and payment bonds on public works projects. These bonds guarantee that the project will be completed and that subcontractors, suppliers and laborers on the project are paid. If the surety backs a contractor that defaults on the project, the full amount of the performance bond is available to complete the work and the full amount of the payment bond is available to pay those who performed work on the job. Congress, all states and most municipalities and local governments recognize the value of these bonds.

The Federal Miller Act

In 1894, Congress enacted the Heard Act to codify the existing practice of requiring public works contractors on federal projects to furnish a bond to assure completion of the contract work and payment of subcontractors and suppliers. In 1935, the Miller Act replaced the Heard Act and required separate performance and payment bonds. The minimum amount below which bonds are not required, the "bond threshold," was set at \$2,000 in 1935 and raised to \$25,000 in 1978. In 1994, the federal law was amended to raise the threshold to its current level of \$100,000. Regulatory revisions have been proposed to increase the threshold to reflect inflationary increases. However, the proposed new level is \$150,000, far lower than the threshold proposed by Bill 18-635.

The federal government also requires “payment security” (with a payment bond one of the options) for contracts less than \$100,000 but greater than \$30,000.

State Bonding Requirements on Public Projects

All 50 states and the District of Columbia require surety bonds on state and local public works projects. The state bond thresholds vary. The majority of states have thresholds of \$50,000 or less. The District is one of several jurisdictions that have moved to the \$100,000 threshold also used by the federal government. In only a minority of the states does the state bond threshold exceed \$100,000. Bill 18-635 would make the District’s bonding threshold the highest in the nation and would set it at a level five times higher than the federal government. SFAA’s compilation of the state bond threshold laws is attached for your reference.

The Impact of Increasing State Bond Thresholds

Many Small Subcontractors Are Left with Far Less Protection

Mechanics liens cannot be asserted against public property in the District. Laborers, subcontractors and suppliers on public projects must rely on the general contractor’s payment bond for protection. If no bond is required, these parties are left with no means to collect for their services and supplies if the contractor is unable or unwilling to pay them. Small, emerging and minority contractors are more likely to start as subcontractors. This is especially true on smaller projects, and the most vulnerable companies will be the ones deprived of payment protection by this bill. If the bond threshold is raised, such subcontractors and suppliers either will have to risk losses from non-payment that they cannot afford or not work on the public jobs for which they are best qualified.

Experience shows that construction contractors face a high risk of failure. According to BizMiner, of the 1,155,245 general contractors and operative builders, heavy construction contractors and specialty trade contractors operating in 2006, only 919,848 still were in business in 2008—a 20.4% failure rate.

Current economic conditions increase the exposure of contractor failure. According to statistics released this March by the Associated General Contractors of America (AGC), construction employment, an indication of construction activity, declined in every state and the District of Columbia over the past 12 months. The District and 38 states experienced a double-digit percentage drop during that period. Construction unemployment was 27.1% in February, according to AGC, compared to the Bureau of Labor Statistics’ national unemployment rate of 9.7% for the same month.

While the general economy may be showing signs of improvement, nonresidential construction continues to struggle. Nonresidential construction typically lags behind the general economy by about 18 months, according to FMI Corp., which projects that nonresidential construction will decline 15% in 2010 after having declined 10% in 2009.

In March, the U.S. Census Bureau reported that total nonresidential construction spending fell 10.6% in January 2010 from January 2009. Public nonresidential construction spending grew

only 2.0% in January 2010 over January 2009.

It is easy to see that with a high bond threshold, a contractor could bid on and be awarded multiple large District contracts for which no payment and performance bond would be required and easily could have a significant amount of unbonded construction under way when financial problems force the contractor into bankruptcy. When a contractor goes bankrupt, it usually does not fail only on one project, but on all. Workers and suppliers on several jobs could be affected. In the current economy, District construction workers and suppliers need payment protection all the more.

There are numerous cases in which unpaid subcontractors and suppliers have been left unpaid by the government's failure to obtain performance and payment bonds. See, for example, *U.S. Dept. of the Army v. Blue Fox, Inc.*, 525 U.S. 255, 119 S. Ct. 687, 142 L. Ed.2d 718 (1999). *N.V. Heathorn, Inc. v. County of San Mateo*, 2005 WL 419462 (Cal. App. February 23, 2005); and *Electrical Electronic Control, Inc. v. Los Angeles Unified School District*, 24 Cal. Rptr.3d 316 (Cal. App. 2005).

Increasing the Bond Thresholds Puts Taxpayers at Greater Risk

The performance bond ensures that the contractor will fulfill its obligations under the construction contract fully. If a performance bond is not provided, District government and ultimately the taxpayers take on the risk that the contractor will default. By raising the bond threshold, there will be more contracts on which taxpayers in the District will bear the burden of re-letting work and paying any excess completion costs.

District Contracting Officials Will Need to Screen and Qualify More Contractors

Among the benefits provided by a surety bond is the qualification process that the surety puts the contractor through to ensure that the contractor is qualified to complete the contract. The surety examines the contractor's expertise and experience in the type of work, character, capabilities and resources, overall management, as well as its capital position and financial track record. Without the performance bond or payment bond, such qualification assessment is left solely to the various departments of the District government for the construction projects that are within the contract size threshold. The District government will be stretched to make such a detailed evaluation of each bidder for a greater number of projects.

Increasing the Bond Threshold May Have Unintended Consequences

Increasing the bond threshold does not necessarily mean that small and/or local District contractors will obtain more District construction business, but rather that all contractors will be able to bid on much larger District projects without being required to provide payment and performance bonds. One result of that may be that larger regional and national contractors will be able to secure more unbonded work in the District, thus freeing up their bonding capacity for bids elsewhere. In the current economy, the sureties have seen larger regional and national contractors bid on and be awarded projects that are much smaller than those they previously sought in a robust economy.

Mentoring, Technical Assistance and Greater Access to Bonding Serve the Contractor More Effectively than Increasing the Bond Threshold

As a contractor grows and the sizes of its contracts increase, it likely encounters more and more projects that must be bonded. Therefore, to grow in the arena of public construction, a contractor needs an established relationship with a surety company. Increasing the level at which the contractor is required to be bonded merely delays the inevitable necessity of developing a relationship with a surety. The contractor benefits when it begins a relationship with a surety early in its growth. The surety can provide guidance as to what is required in terms of financial position, organization and experience in order to obtain bonding "at the next level." Late entry into the bonding market raises the difficulty for a contractor in qualifying for its first bond and, in the long run, increases the likelihood that the contractor may not have the financial and operational profile to obtain bonds for larger projects.

The better approach is mentoring and technical assistance. The justification for increasing the bond threshold or waiving bond requirements is that small and emerging contractors cannot obtain work because they cannot meet the bonding requirement. That view suggests that, but for the bond, the contractor could win the job. This premise, however, is flawed. We can all agree that it is in the District and the public's best interest that projects be awarded to qualified contractors. One of the services of a surety bond is such a prequalification. In underwriting a contractor, a surety reviews the capability and capacity of the contractor and makes an assessment of that contractor's qualification. Therefore, the focus should be on enhancing this capability and capacity so that the contractor can qualify for bonding in the first place, not on increasing bonding thresholds.

We believe that mentoring and technical assistance programs address this issue straight on, while bond waivers or threshold increases ignore or postpone it. SFAA has worked with several government agencies to implement its Model Contractor Development Program, an initiative with the dual strategy of working with surety bond producers and underwriters to make bonds more available and, at the same time, working with the contractors to make them more bondable.

This Program is composed of two interrelated components. First, the Educational Workshops Component offers a set of 10 workshops including an introductory workshop, eight substantive workshops and a closing workshop focused on networking and next steps. The substantive workshops cover areas such as project management, estimating and construction accounting and are designed to provide information to contractors related to improving their companies' operations and thereby making it easier to be bonded or to increase their bonding capacity.

The second aspect of the Model Contractor Development Program is the Bond Readiness Component. This component consists of one-on-one interactions with surety bond producers, underwriters and other volunteer surety professionals who work with the contractors on a case-by-case basis in assembling the materials necessary for a complete bond application and in addressing any omissions and/or deficiencies that might deter the successful underwriting of a bond. We have implemented the program throughout the country, and in just the last two years, more than one hundred million dollars in bonding for small and emerging contractors can be attributed directly to their participation in these initiatives. We recently implemented this program locally with the District's Department of Small and Local Business Development and launched our second round of workshops this month. The contractors from the earlier round

currently are engaged in various aspects of bond readiness preparation, and we already are seeing some success from our efforts.

Other Bonding Provisions in Bill 18-635

Finally, Bill 18-635 also would authorize contracts for design-build; design-build-finance-operate-maintain; design-build-operate-maintain, operations and maintenance; and construction manager at-risk projects. The performance bond and payment bond amounts would be revised in terms of the basis on which the bond is calculated and the percentage of that basis. These revisions apparently are intended to address the different delivery methods. Under current law, performance bonds must be in an amount that the Director of the Department of Administrative Services deems adequate to protect the District Government. Bill 18-635 would require performance bonds and payment bonds to be for 100% of the "portion of the contract price that does not include the costs of operation, maintenance and finance" of the project, but not less than 50% of the "total amount payable by the terms of the contract." The Chief Procurement Officer, however, could reduce the performance bond and the payment bond amount to 50% of this amount through its regulations.

For contracts with operations and maintenance components, the bill would authorize the Chief Procurement Officer to adopt rules for requiring a form of financial security to secure these components of the project. The bill provides that surety bonds could be required to secure the performance of the contractor's operations and maintenance obligations under the contract. Letters of credit and corporate or parent company guarantees also would be accepted. Although a surety bond may be an appropriate means to secure the maintenance and operation obligations in some cases, the long duration of such obligations may make a surety bond difficult to obtain in the market. Thus, alternative forms of security may be necessary.

Conclusion

For the reasons listed above, we feel that increasing the District's bond thresholds is contrary to sound public policy. Bonding requirements exist to provide vital safeguards for those who work on public projects and the taxpayers who pay for them. In addition, there are alternative approaches such as SFAA's Model Contractor Development Program that can achieve the same desired objective of greater access by small, minority and local contractors to District contracting opportunities without increasing the risks to the District government and these contractors that you are seeking to serve.



The Surety & Fidelity Association of America

100 Years of Service: 1908-2008

State Bond Thresholds

The state bond thresholds are the amounts above which bonds are required on state construction projects. In most instances, states may require bonds on contracts below the threshold.

No Threshold	Under \$25,000	\$25,000	\$25,000-\$50,000	\$50,000	\$75,000	\$100,000	Other
Delaware	Arkansas (\$20,000)	Hawaii	Kentucky (\$40,000)	Alabama	Minnesota-13	Alaska California-6 Colorado	Indiana (\$200,000)
Idaho	California-6	Iowa	South Carolina (\$50,000)	Arizona Illinois-7		Connecticut District of Columbia-11	Florida-1
Ohio	District of Columbia-11	Louisiana-8	Washington (\$35,000)	Michigan		Georgia	Maine (\$125,00)
Utah	Illinois-7 (\$5,000)	Mississippi	New Hampshire (\$35,000)	Montana Oklahoma		Kansas	North Carolina (\$300,000)
West Virginia	Massachusetts (\$5,000) Nebraska-5	Missouri	Oregon-9	Rhode Island		Maryland	Virginia \$250,000 for DOT Projects
	Wisconsin (\$10,000)	New Mexico		South Dakota		Nebraska-5	
	Wyoming (\$7,500)	Texas (payment)-12				Nevada New Jersey-2 New York-3	
						North Dakota	
						Oregon-9 Pennsylvania-10	
						Tennessee	
						Texas (performance)	
						Vermont	
						Virginia-14	

Notes

1. Payment and performance bonds may be waived for contracts under \$200,000 for counties, cities, political subdivisions and other public entities. The state Department of Management Services may delegate the authority to any state agency to waive bonds for work in excess of \$100,000 but less than \$200,000. The threshold for DOT projects is \$250,000.
2. Bonds may be waived in certain situations if contracts are under \$100,000 (public entities other than state agencies) or \$200,000 (state agencies).
3. Bonds may be waived by the head of the state agency or commission if the contracts exceed \$100,000 or if it exceeds \$200,000 for a contract not subject to state requirements for multiple award requirements. (Wicks Act)

Certain public authorities in New York that construct medical buildings have individual payment bond thresholds. For the Westchester County Health Care Corporation and the Nassau County Health Care Corporation, the threshold is \$1.5 million, not including the costs of medical equipment and devices. The

threshold for the Clifton-Fine Health Care Corporation and for the Erie County Health Care Corporation is \$500,000, not including the costs of medical equipment and devices.

4. In contracts under \$35,000, the state may retain 50% of the contract amount in lieu of bonds.
5. \$100,000 is the performance bond threshold for the construction, repair and improvement of buildings. The payment bond threshold, which is broadly applicable to all public projects, is \$15,000 for the state and \$10,000 for all other public entities.
6. In California, the threshold for a performance bond is \$100,000. The payment bond threshold is \$25,000.
7. In Illinois, the bond threshold is \$50,000 for state agencies, but \$5,000 for all other public entities.
8. The threshold is \$100,000 for the New Orleans Swage and Water Board
9. Oregon threshold is \$100,000 but \$50,000 for DOT projects.
10. In Pennsylvania construction projects between \$25,000 and \$100,000, performance security is required in an amount of 50% of the contract price.
11. In the District of Columbia, bonds are not required in projects under \$25,000 and may be waived in projects under \$100,000.
12. For municipalities and any joint board created under the Transportation Code in Texas, the payment bond threshold is \$50,000. The payment bond threshold is \$25,000 for all other governmental entities.
13. For city housing and the city redevelopment authorities the threshold for bonds in Minnesota is \$100,000.
14. For Virginia public universities and colleges, as well as Virginia Commonwealth University, the threshold is \$1 million for payment and performance bonds for university construction projects.