



NASBP and SFAA Response to

“Leaving Performance Bonds at the Door for Improved IT Procurement”

NASCIO IT Procurement Modernization Series: Part II

The National Association of Surety Bond Producers (NASBP, www.nasbp.org) is a national trade organization located in Washington, D.C. composed of businesses throughout the U.S., Canada, and Mexico which employ surety bond producers who specialize in furnishing surety bonds to companies and individuals for construction and other commercial purposes.

The Surety & Fidelity Association of America (SFAA, www.surety.org) is a trade association of approximately 450 insurance companies that are licensed to provide surety and fidelity bonds. SFAA members collectively account for the vast majority of performance bonds written to secure public contracts in the United States.

It is the purpose of this paper to respond to the NASCIO membership regarding assertions made in the captioned paper published in August 2012 (hereinafter “NASCIO brief”). It is the understanding of NASBP and of SFAA from statements made by NASCIO that NASCIO sought no information or input, individually or collectively, from the surety bonding community or the organizations representing that community before issuing its brief.

NASBP and SFAA are concerned that the information in the NASCIO brief neither adequately nor accurately describes the services of the surety or the benefits of bonding, nor properly characterizes the intended use of bonding in the procurement process. The NASCIO brief advocates the reduction or the elimination in the use of performance bonds at the expense of protecting taxpayers and contracting authorities. The brief posits that states should assume, not transfer to an established third-party surety, the risk of defaults on information technology (IT) services contracts. The NASCIO brief also advocates the use of an owner’s in-house project monitoring and contractual and legal remedies as preferable alternatives to the surety claims process to prevent or resolve vendor default.

This paper will respond according to statements made within the titled paragraphs in the order they appear in the NASCIO brief. This paper encourages procurement officers to consider surety bonds as a widely accepted and available risk management tool.

Performance Bonds – Friend or Foe?

“Though once easily attainable, the surety market has significantly changed because of a wave of factors external to the IT industry mainly the high visibility bankruptcies of the early 2000s.”

The Surety & Fidelity Association of America (SFAA, www.surety.org) regularly publishes, and the Surety Information Office (SIO, www.sio.org) posts industry results. While the period of the early 2000’s was challenging, since 2005, surety losses have steadily declined, rising only slightly in 2008 to the present date. Surety losses tend to lag the overall economy and, while the industry remains cautious about future profitability, bond capacity currently is not a factor influencing the availability of bonds for IT or other contract types. (SIO “Contract Surety Bond: Understanding Today’s Market,” Publ. 2012, <http://suretyinfo.org>).

“Not all states are required to have performance bonds for contractors, but for those that do it has led to significantly limited competition ...”

Through an owner’s bonding requirement, sureties prequalify viable contenders for public contracts, providing a valuable risk management service to the IT procurement officer, the state, and the taxpayer. The service does reduce the number of potential bidders, because it is designed to screen out companies with insufficient capital or experience, those companies which would pose a higher risk of default on such contracts.

The primary purpose underlying performance bonds on publically-funded contracts is to help ensure that only qualified companies, by virtue of their experience, expertise, and financial wherewithal, are placed in position to seek award of publically-funded contracts. Surety companies extend surety credit only to those companies that, upon completion of an underwriting process and in the surety’s judgment, are determined to be qualified to undertake successfully the contract obligation sought. To make that underwriting determination, sureties examine various facets of the business applying for surety credit, including its references, reputation, equipment, management team, track record, and working capital. In the unlikely event that the bonded IT company defaults or becomes insolvent, the surety company stands ready to provide a remedy up to the penal sum of the bond, which in some cases is to complete the services contract and in other cases is to make a financial settlement so that the owner can complete the project or re-procure.

Surety bond requirements improve the quality of competition by eliminating unqualified companies from the pool competing for award of public contracts.

“smaller companies don’t have the capital to qualify for high dollar performance bonds, smaller companies suffer from limited bonding ability by the surety market, and bond collateralization can create an adverse impact for smaller businesses.”

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The surety industry is sensitive to small contractor bond capacity issues and, for many years, has co-sponsored educational and mentoring programs in connection with construction contracts to promote ways the small contractor can qualify for bonding. One recent example is illustrated in the *MCDP Spotlight: The Surety and Fidelity Association of America* Newsletter Vol XXIX, Issue 6, Sept/Oct 2012. SFAA and NASBP would welcome the opportunity to work with NASCIO in establishing a technical assistance program in connection with IT service contracts.

It is not clear what NASCIO means by the term “high dollar performance bonds.” Presumably “high dollar performance bonds” relates to the scale or size of the contract sought by the small business. If NASCIO means that small businesses may not be able to obtain surety bonds for projects with large contract amounts, then the premise is reasonable. The primary barrier for small contractor access is the size of the procurements, rather than the size of the bond. A surety underwrites a performance bond based on the scope of the contract. The risk to the surety is that the contractor will not be able to complete the contract. If the contractor defaults, the surety’s obligations under the bond are triggered. The bond secures the performance of the whole contract, not just a percentage of the work or a portion of the loss. To a surety underwriter, a bond that is in the amount of 100% of the contract price presents a very similar risk as a bond that is in the amount of 50% of the contract.

Plenty of capacity does exist in the surety marketplace for qualified businesses, including those of small size. However, those businesses that meet many of the surety underwriting requirements, but may fall short on financial strength, still have options for qualifying for surety credit. Specifically, some surety markets will permit businesses with the necessary experience and expertise to gain surety credit through collateralizing their bond obligations. IT services companies that do not wish to collateralize their bond obligation may be able to provide to the contracting authority other means of security, such as escrow arrangements or letters of credit, to secure their public IT services contracts. The key point is that taxpayers should be protected through imposition by state contracting authorities of security requirements, of which surety bonding is an important option, when state governments award contracts for goods and services, including IT services contracts.

“In addition, the cost of obtaining any bond has exponentially rose – in some instances 40 times higher than the cost of an existing bond prior to the corporate scandal period.”

Throughout its 100-year history, bond rates on contract surety have consistently remained within a narrow range - *decreasing* as the contract size *increases* - of 3% down to .5% of total contract amount. Bond rates on commercial surety, such as service contracts, also are in a close range, typically from 1% to 2%. For that reason, bond premium rates on surety bonds of all types have been and continue to be very competitive.

Performance Bonds are not Insurance Policies

Although surety is a type of insurance, surety bonds function similarly to credit instruments, rather than like typical insurance policies. In fact, surety companies operate under a business model that is intended to prevent losses, a marked distinction from the business models applying to most other types of insurance. To put it another way, sureties underwrite under a business assumption that credit is given only to those that will perform successfully; therefore, bonds are underwritten with little or no expectation of loss. The bond premium includes a charge for the surety undertaking the risk or exposure to be bonded. However, much of the premium consists of a fee for prequalification services. As a result, premiums for surety bonds are inexpensive relative to the degree of risk being assumed by the surety company.

“Hence, a performance bond is not an indemnity instrument and recovery of damages can be achieved through insurance, warranties, or other contractual and legal remedies.”

Performance bonds are superior to insurance policies, indemnity agreements, or contractual remedies in covering performance risk, in that the surety can intervene in a number of ways before a defaulted contractor costs the owner/taxpayer anything. Indemnities and contractual remedies are only as effective as the good will and the solvency of the IT firm performing the services contract. If the IT firm refuses or fails to honor such contractual remedies, the contracting authority will be forced to pursue litigation to enforce the remedies, with likely little hope to recover sufficient funds or assets, especially from small or thinly capitalized firms. Even worse, should the IT firm become insolvent, the contracting authority will have limited ability to pursue recovery. Surety bonds, on the other hand, are intended to address those very circumstances by ensuring that the awarded IT firm possesses sufficient financial assets in the first place and, should that firm go insolvent, a deep pocket is available to cover the costs arising from the default.

Balancing the Scales of Risk vs. Reward

“Vendors considering competing for state IT contracts may be chased away by high bond percentage requirements. This can lead to reduced competition and actually push out small businesses that would otherwise participate.”

“Several states and the Federal government have already abandoned the use of performance bonds because of the low value they provide to IT contracts.”

While bond guarantees to the owner are a very visible benefit, the most important purpose, as mentioned earlier, is the collective screening or prequalification of capable, financially strong, and successful bidders. As noted above, competition among qualified candidates is not reduced.

The North Dakota Experience – Takeaways

“In software development projects, the surety companies have a difficult time evaluating the work and projects that are not functional may need to completely start over.”

It is true some projects are very challenging to fix, especially where there is a proprietary software program or expertise that has disappeared with the vendor. In some circumstances, starting from scratch may be the best option. In any case, the project owner should assess its exposure arising from a default and set the appropriate bond amount accordingly, whether the amount represents the costs to complete the project or the costs simply to obtain a new contractor.

In the North Dakota situation, the North Dakota Public Employees Retirement System (NDPERS) required a “20% performance bond,” which meant that the penal sum of the performance bond represented only 20% of the original value of the software development contract. Did NDPERS contemplate the full exposure arising from a default, including the redevelopment of the software “from scratch” in establishing the bond amount of 20% of the contract price? Any monies to be expended past that point to fix the default are an exposure borne by the contracting agency.

“The surety companies that did take software bonds wanted 100% collateral. The cost of tying up that much operating capital was directly passed back to the client, NDPERS.”

Collateral may be required to secure the principal’s indemnity when the surety is not confident in recovering from the principal in the event of project default. Cash collateral posted with the surety should not cost anything to the owner unless the vendor is trying to pass on the interest cost of a drawn credit line or the price of an irrevocable letter of credit (usually 1.5% of collateral requirement). Owners should make an effort to know the costs of bonds and either specifically state on the bond form (as the Federal Government and some States) or in the contract, the amount or range the owner is willing to pay for the bond.

The “Eureka” State

Actions of the State of California are cited throughout the NASCIO brief, including California’s recent decision to eliminate a mandatory bonding requirement with respect to the procurement of IT goods and services. California may find its decision to be an unfortunate and costly one, as it exposes its taxpayers to all losses on the default of such contracts. Considering the other 49 States experiences would surely have given a more balanced view of IT procurement practices and bonding. However, since California was selected as a model, consider the recent case of the Oakland Police Department’s failed IT procurement experience: “*Audit Finds OPD Lost Nearly \$2 Million On Failed Technology Projects*”: By Tawanda Kanhema, Posted August 2, 2012, Oakland North, <http://oaklandnorth.net>.

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Among the problems discovered, auditors found that, at a cost of \$1.87 million, four technology system services “were underutilized or never used because the technologies’ manufacturers went out of business.” According to the auditors’ report: “no performance bonds had been signed with any of the startups providing these technology systems when their makers folded, resulting in a loss for the city.” The report did state that “This [buying performance bonds] has always been an option, but proves difficult when dealing with small, privately owned companies who target the public safety market.” However the auditor recommended: “to obtain performance bonds for all new technology contracts, ensuring that vendors take full responsibility for their products and guarantee a refund in case the vendor goes out of business.”

Department Chief Howard Jordan aptly concluded: “Anytime you spend public money, you have to be frugal with it.” That money [\$1.87 million] is enough to hire 20 more cops for a resource-strapped city that we are.”

Payment and Other Contract Terms

“While vendors may invest substantial resources to IT projects as they progress, there aren’t necessarily any payments until the project is completed and the state has approved the outcome.”

Payment terms could be a strong factor for preventing small contractors from participating in procurements. Very few businesses have the capital to internally finance 100% of a project to completion; even fewer will consider bidding such a project.

Hand-in-Hand Collaboration and Performance Monitoring

“...the state can continually monitor the contractor’s progress in successful solution completion and can take swift action in the event that its performance is not conforming.”

We agree that owner monitoring is a sound risk management tool. However, it may not be sufficient in all circumstances. As illustrated in the aforementioned Oakland PD example, owner monitoring cannot prevent vendor default. The owner cannot monitor the vendor’s other unrelated projects that can also cause complete enterprise failure. A surety monitors its clients on an ongoing basis, requiring quarterly or even monthly financial reporting on all work, both bonded and un-bonded, evidence of insurance and credit lines drawn, and much more. A public contracting authority likely does not have the resources to undertake as broad, thorough, and complete a monitoring process as that undertaken by surety companies.

Protecting the State Interests

“Beyond the fact that bonds, in high or low amounts, are not incentives for contractors to perform under contract ...”

A vendor or contractor’s true incentive to complete a project correctly and on time is the profit earned plus future profits realized indirectly from its advertised success, and referrals. There is no stronger incentive.

In addition, because a contractor agrees to indemnify the surety for losses the surety incurs in remedying the default, the contractor’s financial interest to complete the project is strong. “In an indemnity agreement, the contractor promises corporately and sometimes personally (including spouses) to reimburse the surety for any loss it might sustain as a result of having written the bond.”

Remember that sureties underwrite to prevent losses. They expect their principals (those to which are extended surety credit) to reimburse them for any monies paid out under the performance bond. Each bonded firm has “skin in the game” regarding their contract and bond commitments because the general agreement of indemnity required by the surety of the IT firm ensures that to be the case.

“...performance bonds are also not an effective means for protecting the state. Performance bonds are rarely, if ever, paid because years of litigation to determine the amount owed and disputes are usually settled.”

No service is 100% perfect, but this statement clearly contradicts over 100 years of federal and state contracting and procurement history, where billions of dollars have been paid to owners on defaulted projects of one kind or another. Further, measuring the paid losses made by a surety is only a partial way to assess the value of a surety bond. The benefit obtain by prequalification must be considered. Consider the *hundreds of billions* of dollars of completed projects by properly vetted and bonded contractors; one wonders how many of these projects would have gone into default without surety oversight and guarantees.

More and more private owners are requesting or requiring bonds on everything from the construction of single family dwellings to golf courses to performance of international trade contracts. Recently, China has begun to request bonds on supply contracts with U.S. vendors.

“States have numerous other contractual, legal, and financial remedies to make states “whole” in the event of failure to perform. Figure 3 lists a few remedies that states can use in lieu of performance bonds.”

Performance bonds must be a risk mitigation tool considered by procurement officers. Dismissing the use of bonds in all cases deprives the public of the benefits of bonds. Consider the following benefits of performance bonds:

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- Prequalification
- Financially-sound corporate third-party guarantee of performance
- Surety support and resources to bonded IT firm to avoid default in the event problems arise
- Remedies, including monies, available to address default (paid out up to penal sum of bond)
- Financial monitoring of all projects of the vendor that could contribute or cause complete enterprise default
- Protection of taxpayer money and resources

Again, the NASCIO brief advocates a preference of contractual remedies, such as warranties, indemnification, liquidated damages, suspension of performance, among others, over requirements for performance bonds. Although such contractor remedies may be sufficient in some cases, they may fall short in other circumstances. Performance bonds may be an effective tool to supplement these contractual remedies. All contractual remedies depend on the solvency of the contractor for recovery by the contracting authority. Even if the IT firm remains solvent, it may not have sufficient assets for recovery by the contracting authority to make a lawsuit economically viable. Then what? The state self-financed the risk of performance and has no third-party guarantee from which to recover its default costs.

“Top 3 Recommendations for Performance Bonds –

...

- 1. A reasonable limitation of the application of the performance bond requirement will increase competition. ...*
- 2. States have other more effective contractual protections that are more effective than performance bonds, such as service level agreements in appropriate projects, warranties, and acceptance criteria. ...*
- 3. Performance bonds should not be broadly required because, in addition to changes in the claims surety market, the original intent has changed with emerging technologies:*
 - a. Bonds are difficult to secure, time consuming, and expensive to the states.*
 - b. Bond collection is rarely triggered under IT services contracts.*
 - c. Perhaps most importantly, the Federal government and several states have abandoned the requirement of performance bonds in IT service contracts.”*

Throughout this response we have challenged the notion that bonding is a low value service.

Waiving bond requirements solely to attract bidders does not make the low bidder any more able to handle the contract once the bidder obtains the contract. In fact, it shifts the exposure of potential default to the owners. Surety bonds are and can be an effective tool for addressing this financial exposure.

Conclusion

The NASCIO brief provides an incomplete perspective on the relevancy of performance bonds to IT services contracts. The brief makes clear that state agencies are under considerable pressure to save costs, but they should not do so at the expense of and the protection of taxpayer interests. A “penny wise and pound foolish” approach to procurement can lead to unfortunate results for taxpayers and contracting authorities; one where there is no remedy available except the expenditure of additional taxpayer funds. To avoid that circumstance, vendors seeking award of procurements for IT goods and services should be expected to provide some form of security, including the option to furnish a performance bond, to secure their contract performance.

Admittedly, there are unique challenges to IT contracts and vendors that do not exist in physical construction projects. In addition, bonding may not be the appropriate risk management approach in all cases. These challenges, however, do not form sufficient reasons to eliminate performance bond requirements as a prudent and preferred means of security on all procurements for IT goods and services. NASBP and SFAA invite NASCIO to work together with the surety community to address concerns on the role and functioning of surety bonding in the IT procurement environment. Collective discourse will bring a broader understanding and the ability to find answers to concerns that avoid leaving the sole burden of default costs at the feet of state taxpayers.