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August 27, 2013

Mr. Pernel Jones, Jr.
Chairperson
Public Works, Procurement & Contracting Committee
Cuyahoga County Council
1219 Ontario Street Room 424
Cleveland, Ohio 44113

Re: Comments Regarding Proposed Ordinance 2013-0018

Dear Chairman Jones:

On behalf of the National Association of Surety Bond Producers (NASBP), a national trade association whose membership includes firms employing licensed producers resident in Cuyahoga County, in Ohio, and elsewhere in the country and who place surety bonds on contracts in Cuyahoga County and in other jurisdictions, I respectfully submit the following comments on proposed ordinance 2013-0018.

I had the opportunity to listen to the Committee's August 21st hearing via web stream and would like to offer the following responses to Cuyahoga County's Director of Law's statements regarding the surety product and particularly performance and payment bonds. Statements from the hearing made it clear that the purpose behind the introduction of the ordinance is to provide greater access to public construction contracts by small and emerging companies. However, statements made by the Director of Law at the hearing reinforce the strong belief of NASBP that the ordinance, and its inherent subjectivity, would, in fact, produce the opposite effect. The alternatives to performance and payment bonds mentioned by the Director of Law in the hearing, we fervently believe, would not provide greater opportunities to small businesses and would jeopardize precious taxpayer dollars.

The Director of Law posited that a subcontractor default insurance (SDI) product, such as Subguard®, is a comparable alternative to performance and payment bonds. SDI is not an equivalent product in function or coverage. In fact, SDI should never be considered a replacement or substitute for bonds at the prime contract level. An SDI policy is an insurance product to address the prime contractor's risk of subcontractor default, not the County's risk of prime contractor default. The prime contractor/construction manager (CM) is the insured party, and the coverage of the policy is triggered by a subcontractor default. Any insurance payment due is made to the prime contractor/CM; SDI does not provide a benefit to the county/public owner for the default of the prime contractor/CM. Thus, in the absence of performance and payment bonds from the prime contractor/CM, the county retains the performance and payment risk of the prime contractor/CM, that has received the contract for the total cost of construction. SDI also does not provide payment remedies for the benefit of unpaid subcontractors and suppliers. Again, the SDI policy exists for the benefit of the prime contractor which has elected to address its downstream subcontracting risks through such a product; unpaid subcontractors and suppliers are not beneficiaries of the SDI policy. However, these critical benefits—a contract performance guarantee to the project owner and payment remedies to unpaid subcontractors and suppliers—are present when the prime contractor/CM furnishes the project owner with performance and payment bonds covering its obligations.

You should also know that SDI is a form of partial self-insurance by the prime contractor of its downstream risks—that is, the prime contractor using an SDI program still has substantial co-payments and deductibles to access the policy. If the prime contractor experiences no losses from enrolled subcontractors in its SDI program, the prime contractor potentially will realize a higher profit. For this reason, prime contractors utilizing SDI programs have a disincentive to enroll small and emerging subcontractors with questionable financial wherewithal. If a small, emerging construction company cannot be bonded, what incentive does the prime contractor have for enrolling that subcontractor in its SDI program when it assumes part of the financial risk of that subcontractor's performance?

The Director of Law also stated that corporate guarantees may be an acceptable alternative to performance and payment bonds from the prime contractor/CM. Please keep in mind the size of the contractors that can offer corporate guarantees. If the purpose of the ordinance is to provide opportunities to small companies to access public contracts at the prime level, those companies are not the ones that can offer such guarantees. A corporate guarantee is only of worth when the corporation is sufficiently liquid to provide a meaningful guarantee. Otherwise, the corporate guarantee is worthless, and performance risks have not been properly allocated. How are such alternatives to performance and payment bonds going to benefit small business access to public construction contracts?

The Director stated that access to capital is problematic for small businesses. We concur with that statement. Currently, access to capital is very difficult for almost all sizes of businesses due to strict lending practices resulting from the financial collapse several years ago. As an organization, NASBP has long advocated for capital access programs for small and emerging businesses, which would position such businesses to meet the underwriting criteria for financial and surety credit and to be placed on the path to long-term viability. We encourage the Committee to explore ways in which such a program could be developed.

Throughout the course of the hearing, the statutory requirement of bonds was often referred to as "arbitrary" because other county contracts or services, such as certain technology service contracts did not require bonds. The Director views construction as a "sacred cow." The Director of Law, however, overlooks the fact that the construction process is a unique and distinctive process, inherently more variable than the processes for manufactured goods or singular services, which occur in non-variable environments. A unique body of procurement practices and laws has developed in recognition of this fact. For example, at the federal level, the Federal Acquisition Regulation provides unique requirements and contracting provisions expressly for inclusion in construction procurements.

It has been said that no business is more exacting or requires greater effort and determination than construction. Indeed, construction is complex and challenging, because, among other reasons, it requires interpretation of and conformance with myriad laws, codes, and regulations; the marshalling of considerable resources, including labor, equipment, and material; and communication with and coordination among many parties, such as the design professional, contractor, subcontractors, and suppliers, all of whom may, at times, have different, even conflicting, purposes and goals. Moreover, many factors are unknown or unknowable at the start of any project. Not surprisingly then, proper management of risks should be an expected part of this process. The necessity of surety guarantees due to the high failure rate of construction businesses precipitated the enactment of the statutory bonding requirements now in place at all levels of public procurement of construction services. Proper procurement of construction services recognizes the unique nature of the construction process and the risks it presents.

The Director also offered that the County would be able to perform an individual risk analysis of each contractor on “a contract-by-contract basis”. Such a statement presumes that adequate resources are in place to perform such an intensive analysis. Yet, prequalifying contractor’s directly by government agencies, which typically are limited in resources and subject to the ebb and flow of public budgetary processes, likely would be much more restricted than that performed by surety companies, which are in the regular business of underwriting construction businesses. When a contractor is underwritten by a surety, the surety examines the character, capacity, and capital of the contractor and then routinely re-examines the financials and monitors the contractor’s performance of the bonded work and other work in progress. The surety forms a comprehensive, and, most importantly, continuing view of the abilities of the construction firm. The County would not have the ability to perform prequalification and monitoring at the same level and likely would only have access to the contractor’s pertinent information at a single moment in time during the procurement process.

Vesting the Director of Law with discretion to assess the need for a performance bond requirement on “a contract-by-contract basis” is fraught with subjectivity. The rationale for each decision on bonding requirements for each construction procurement likely will be unknowable by companies seeking contract award. What might be an outcome of such subjectivity? You actually already heard the answer in the hearing testimony. Subcontractors and suppliers will be forced to introduce higher contingencies in their bids to cover the increased risks of nonpayment. This, in turn, will drive up the costs of the bids, increasing, not reducing, the costs of such projects to taxpayers. Construction contracts not covered by bond guarantees could experience catastrophic losses, resulting in additional expenditure of public funds. Small businesses might even view pursuing public work as too risky, reducing competition further.

NASBP strongly urges the Committee to reconsider the wisdom of this ordinance and to review alternative ways to achieve its laudable purpose of greater small business inclusion in public procurement. The protection afforded to Cuyahoga County by performance and payment bond requirements is too vital to forgo and an excellent and cost-effective use of assets. If you have any questions, please do not hesitate to contact me at 202-464-1217 or at lleclair@nasbp.org.

Respectfully submitted,

Lawrence E. LeClair
Director, Government Relations

cc: Members of the Committee
Mark McCallum, CEO, NASBP
Martha Perkins, Esq., NASBP