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September 15, 2011

Mr. Randal Howard
Mr. Dan Kaman
Ohio Department of Administrative Services (DAS)
30 East Broad Street, 40th Floor
Columbus, OH 43215-3414

Re: Initial Draft Proposed Surety Bonding Rule for Design-Build and Construction Managers at Risk Projects as directed by HB 153

Dear Mr. Howard and Mr. Kaman:

On behalf of the National Association of Surety Bond Producers (NASBP), a national trade association representing professional surety bond producers, including licensed resident and nonresident producers doing business in Ohio, I am contacting you concerning the initial draft rules contemplated by DAS as directed by the enactment of the state's budget bill, H.B. 153. NASBP understands that DAS is mandated to submit final proposed rules to the Joint Committee on Agency Rule and Review (JCARR) by September 30, 2011.

By enacting, Title 1, Chapter 153.54, the statute requiring the furnishing of payment bonds by contractors performing public construction contracts, the Ohio Legislature recognized the importance of having payment bonds in place to protect the downstream businesses that supply labor and materials on Ohio public construction projects. Often these business entities, the project subcontractors or suppliers, are small businesses whose only viable remedy in the event of nonpayment by the prime contractor is to claim on the payment bond.

153:1-4-02, Type and Amount of Surety Bonds

As proposed in 153:1-4-02, Type and Amount of Surety Bonds, DAS contemplates a sliding scale or "gap" bonding approach for Construction Manager (CM) at Risk or Design-Build (DB) projects. For projects less than $20 million, the CM or the DB shall provide 100% bonding for the entire contract sum. This requirement follows current Ohio law (§153.54)(A)(1), which requires a bond for the full amount of the contract or bid amount, which is also the statutory requirement in several neighboring states, including Indiana, Kentucky, Pennsylvania, West Virginia, as well as the Federal Government.

However, for projects greater than $20 million, 153:1-4-02 requires a CM or DB to provide a surety bond of 50% of the contract sum with the remaining 50% to be covered by bonds from the first tier subcontractors. This would make Ohio law very distinct in this regard. NASBP is not aware of any other state or jurisdiction that would have such a unique bonding approach. Such a bonding approach would place greater burdens on contracting agencies and would leave first tier subcontractors without sufficient payment remedies, as they would be limited to the 50% payment bond furnished by the CM or DB and would not be able to claim against the payment bonds furnished by other first tier subcontractors.

By receiving performance and payment bonds in 100% of the contract amount, Ohio contracting agencies receive assurances that, in the event of a default, they have the necessary funds available to cover the total cost of the project and to cover payment for the downstream parties supplying labor and materials on the project. If a CM or DB providing a partial bond (*50% as proposed in 153:1-4-02*) should default, the project owner can pursue a claim against the surety only to the extent of the CM or DB's bond amount. The owner cannot pursue claims against individual subcontractors where there is no privity of contract with such firms. Moreover, even if the owner is listed as a dual obligee (*see 153:1-4-03(c))* on first tier subcontractor performance and payment bonds, the owner can only claim on a subcontract bond where the subcontractor has defaulted on its subcontract obligations. In such circumstances, the owner is limited to the penal amount of the subcontract bond, which is likely to be far less than is required to remedy the default. Such a complex bonding approach places greater cost, time, and administrative burdens on project owners, burdens that do not exist if the owner receives performance and payment bonds from the CM or DB in 100% of the contract sum.

For example, a project problem resulting from multiple defaults—those of the CM and of multiple first tier subcontractors—will necessitate the project owner notifying and negotiating with multiple surety companies, all of whom may differ in their surety claims philosophies, practices, and administration. Again, the project owner likely will be devoting more internal and external resources to addressing a significant project problem. A clear advantage of a requirement for surety bonds in 100% of the contract sum is that, at the point when enforcement is required, the owner has a single surety company against which to assert its claims. Administratively, the owner would only need to make and monitor one claim.

Furthermore, requiring bonds in amounts less than 100% of the contract sum will not make surety credit more available. Before a surety extends surety credit, the surety conducts a careful and thorough underwriting process to assess the contractor's ability to perform the construction contract and to pay its subcontractors and suppliers. The surety reviews the character, capacity, and capital of the contractor, and provides a bond only if the surety finds that the contactor possesses the wherewithal to fulfill its contractual obligations successfully. Partial bonds—bonds for less than 100% of the contract amount—do not lessen the surety's underwriting scrutiny of the contactor. The surety views the contract risk as the total contract obligation, not simply the face amount of the bond. The surety also will base its bond premiums—fees charged for the bond—on rates filed with the state insurance department. These filed rates are predicated on contract amounts, not bonds amounts. In short, partial bonds neither make bonds easier to obtain nor reduce bond premium costs. Partial bonds, however, do provide for less coverage to the project owner and to claimants should the bond principal, the contactor or the subcontractor, default.

For these reasons, we strongly urge that state officials not create a bonding approach that would permit bonds in amounts less than 100% of the contract amount. Reducing the penal sum will neither save costs nor facilitate bonding to those businesses which otherwise would not qualify for surety credit for that contract. Reducing the penal sum, however, will reduce significantly the assurances provided to contracting authorities and to subcontractors.

I would be happy to discuss these concerns with you in further detail. Please feel free to contact me at 202-686-3700 or lleclair@nasbp.org.

Yours sincerely,

Lawrence E. LeClair
Director, Government Relations
National Association of Surety Bond Producers