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BY U.S. MAIL and ELECTRONIC TRANSMISSION
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June 4, 2014

Ms. Christine Ward
Administrator, Procurement & Contracts
Pasadena Unified School District
351 South Hudson Avenue, Room 102
Pasadena, CA 91101

Re: Bond Forms for Pasadena Unified School District Washington Accelerated ES—New Construction/Campus Enrichment Project, Bid No. 12-13/14

Dear Ms. Ward:

I am contacting you on behalf of the National Association of Surety Bond Producers (NASBP), a national trade association of surety bond producers, including licensed resident and nonresident producers placing bid, performance, and payment bonds in the State of California and all other jurisdictions. NASBP was recently forwarded a copy of the Performance Bond and Payment Bond for use on the Pasadena Unified School District (PUSD) Washington Accelerated ES—New Construction/Campus Enrichment Project (Project). We have reviewed these bond forms, and the terms and conditions of these forms give NASBP great concern. More specifically, we believe that these bond terms and conditions are counter to prevailing surety and construction industry practices and to the market reputation of PUSD as a desirable procurer of construction services. I note that these bond forms are appearing in a number of bid documents for public projects in the state of California, and they are counterproductive to the interests of the public authorities. While I expect that the drafter of these bond forms thinks that the onerous terms protect the public interest, they, in fact, do just the opposite.

A number of the terms and conditions in bond forms substantially increase the risks to both the contractor and the surety. This increased risk will almost certainly affect the number of contractors that are able to submit bids for PUSD projects. These documents are drafted so broadly, so vaguely, and so ambiguously that they could act as a significant deterrent to sureties wishing to write bonds for the Project. Indeed, the language in these forms, in essence, turns the surety into a liability insurer for the Project, ignoring fundamental distinctions between surety bonds and insurance policies. We provide below general commentary and comments on specific terms and conditions that will elucidate our concerns and that we hope will be beneficial to you.

Surety bonds do not function like traditional insurance policies. Rather, surety bonds function more in the nature of credit arrangements in which sureties extend surety credit to qualified contractors in return for premium payments. A contract of suretyship is a three-party contract whereby the surety underwrites with the expectation of no losses, because the contractor has been carefully prequalified as to its ability to perform the obligation of the construction contract, and the liability for incurred losses, if any, remains with the contractor. A surety seeks to avoid default by its contractor/principal by examining all facets of the contractor's operations, especially its experience, capabilities, and financial soundness. As a result, the fee payable to the surety is more in the nature of a fee for the prequalification process undertaken and the surety credit extended.

A traditional insurance policy, such as a property insurance policy, on the other hand, is a two-party contract on which the insurer expects losses. Insurance premiums are actuarially computed on the assumption that certain losses will occur, based on averages. Unlike sureties, which write bonds only for contractors qualified in relation to specific projects, insurers generally write policies that spread the risks of losses over the entire pool of insureds. Understanding these critical distinctions is important in understanding that sureties do not write contract bonds or calculate premiums with the assumption of being a liability insurer for such purposes as third-party tort liability or property damage. Rather, sureties issuing contract bonds are guaranteeing the contractor's ability to perform the contract and to pay subcontractors and suppliers--and are not acting as insurers for the project.

The Performance Bond and the Payment Bond permit the obligee to recover attorneys' fees above the penal sum of the bonds. This condition does not comport with customary practice in the surety industry; it is standard that the surety's maximum liability is capped by the penal sum of the bond. The language of the Bond Forms "opens" the penal sum. Such a condition makes it more difficult for the surety to assess its risk, and less likely that it will issue a bond with such a condition.

Furthermore, the Performance Bond is deficient in other ways. It provides that the surety's obligation is "to pay and perform all obligations of Principal under the contract, including, without limitation, all obligations with respect to warranties, guarantees and the payment of liquidated damages." The broad and ambiguous phrase "without limitation" creates significant uncertainty regarding whether the penal sum is a true limitation, a condition for which the surety is unable to assess the risk. This condition is so broad and so vague that it invites disputes and litigation.

Another onerous provision in the Bond Forms is that the surety will not be released from the bond obligation for any reason whatsoever, including overpayment by the obligee. A pro tanto release of the surety for the obligee's overpayment is a typical defense upon which a surety relies. Elimination of this defense again increases the risk to the surety.

The Performance Bond provides that the surety is liable "for all patent and latent defects that arise out of or relate to the Contractor's failure and/or inability to properly complete the Public Work as required by the Contract and the Contract Documents." This provision is particularly objectionable to sureties and their principals, as such should be covered by a contractor's comprehensive general liability policy. By providing for this improper coverage, the Performance Bond becomes a form of project insurance, a role that is improper and a purpose for which it decidedly not created. Even were a surety to write such a bond, it would increase the cost of the project, decrease competition, and impose liability on the surety more akin to project insurance than a performance guarantee.

The Performance Bond further provides that the surety's completion options are, at the owner's "sole discretion and election," dictated solely by the owner. While bonds sometimes limit the performance options available to the surety in the event of a default, generally the surety's options are very broad; and they are the surety's options, not the owner's options. It is customary in the industry that the surety determines its completion option. Additionally, the Performance Bond provides that the owner "may reject any agent or contractor which may be proposed by Surety . . . ." Typically, bonds state that the owner's acceptance of such a contractor proposed by the surety will not be unreasonably withheld. In short, a surety under the Performance Bond could potentially have absolutely no choice for its completion option. A surety would find such strictures on its choice of options unpalatable, and it would be hard-pressed to write any such bond for other than the largest, most highly capitalized contractors. This language, among other, will chill surety participation in the process, an undesirable result on an important public project, such as the PUSD Project.

The Payment Bond provides that the "sole condition of recovery" is that the claimant is a person described in the California Civil Code § 9100 who has not been paid in full. Whether intended or not, such a "sole condition" suggests that the surety waives any time limitation to its exposure under the Payment Bond. Such bonds are generally for a discrete period of time, typically, for one or two years. Lengthy bond periods are problematic from a surety underwriting perspective. Durations longer than two years increase substantially the uncertainty regarding projections about the contractor's future viability. Sureties cannot gauge the soundness and financial wherewithal of a construction company for periods extending too far into the future.

The Payment Bond further stipulates that the surety will not be released from the bond obligation for any reason whatsoever (with the sole exception of fraud by the claimant), including but not limited to "any conditions precedent or subsequent" (which could include notice of a claim). Elimination of the surety's customary right to receive notice of a claim further increases the surety's risk, making it more difficult for a surety to issue a bond on this Project.

These overly broad terms and conditions place undue risk on contractors. When contractors seek surety credit for contracts and bonds with onerous terms and conditions, sureties are much less likely to extend that surety credit. The sureties will not issue such bonds, except to the very largest, most highly capitalized contractors. By including such onerous terms, the PUSD is restricting competition and ensuring that the State pays more for the work. In addition, such policy does not comport with one the State's top priorities—to award work to small, emerging, and minority business enterprises, such as disabled veteran business enterprises, for which California state law requires a certain percentage of participation in state contracts.

For these reasons, NASBP respectfully requests your reconsideration of imposing such onerous bond terms and conditions on the contractors and sureties on the Project. We respectfully recommend that you revise the bond forms to accord more with industry practices and standards. Alternatively, you may wish to consider adopting the well-known standard bond forms developed by industry organizations, which could be amended appropriately to address specific concerns. These include the American Institute of Architects (AIA A312-2010 Performance Bond and Payment Bond), ConsensusDocs (ConsensusDocs 260 Performance Bond and ConsensusDocs 261 Payment Bond), and Engineers Joint Contract Documents Committee (EJCDC C-610 Performance Bond and EJCDC C-615 Payment Bond). Among the benefits of these forms is that they are well-known in the industry and have been well-tested in the court system.

I appreciate your consideration of our concerns, and I would be happy to answer any questions you may have. NASBP would be pleased to work with you to craft bond language that would properly provide contract performance protection to PUSD, as owner, and payment protection to certain laborers and suppliers.

Yours sincerely,

Martha L. Perkins

Martha L. Perkins
General Counsel

cc: Mark H. McCallum, CEO
Larry LeClair, Director of Government Relations