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BY ELECTRONIC TRANSMISSION (joe.dixon@sausd.us)

June 13, 2014

Santa Ana Unified School District
Construction Department
Attn: Mr. Joe Dixon, Assistant Superintendent
1601 East Chestnut Avenue
Santa Ana, CA 92701

Re: SAUSD Wilson Elementary School New Building Addition and Sitework; Project No. 04-112251

Dear Mr. Dixon:

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 Subcontractor Faithful Performance Bond (Performance Bond) and Subcontractor Payment Bond (Payment Bond) for use on the Santa Ana Unified School District (SAUSD) Wilson Elementary School New Building Addition and Sitework, Project No. 04-112251 (Project).

NASBP has reviewed these Project bond forms, and the terms and conditions of these bond forms give NASBP great concern. We firmly believe that very few, if any, sureties that review these bond forms will write such bonds. Indeed, the Performance Bond is one of the most unworkable bond forms that we have ever seen. The bond terms and conditions are counter to prevailing surety and construction industry practices and to the market reputation of SAUSD as a desirable procurer of construction services.

The structure of the Performance Bond does not comport with industry practice and is entirely unworkable. Under the terms of the Performance Bond, the subcontractor/principal and its surety are "jointly and severally held and firmly bound to the Contractor and the District . . . ." Industry standards provide that subcontractor performance bonds guarantee that the subcontractor/principal and its surety will be bound to the contractor, but not to the contractor and the owner as well. The subcontractor's contract is with the prime contractor, not with the SAUSD.

The standard practice provides that, pursuant to the relevant Little Miller Act, a public owner, such as the SAUSD, must require a performance bond and a payment bond from its prime contractor, with the owner as the obligee, for contracts over a certain threshold amount. The

owner/obligee can require the prime contractor to obtain performance and payment bonds from its subcontractors on the project. In addition, the prime contractor can elect to require subcontractor performance and payment bonds from its subcontractors, with the contractor as the obligee. Thus, both contractor and subcontractor bonds can, and often do, appear on the same project. But the obligee for contractor bonds is the owner (and sometimes the owner and the owner's lender), and the obligee for subcontractor bonds is the prime contractor.

And, practically speaking, the process issues of this Performance Bond, with both the SAUSD and the prime contractor as obligees, would be, quite frankly, an untenable nightmare for all concerned. So many actions and processes require the approval of both or either the SAUSD or the prime contractor. To cite just a few examples:

- In section 1: "Upon written notice from the District or Contractor to the Surety . . . ."
- In section 1(c): "Subject to the prior written consent of the Contractor and the District . . ." and "denied in the Contractor's or the District's sole discretion . . . ."
- In section 6: "The Surety hereby waives notice by Contractor or District . . . ."

It is simply poor risk management and unworkable to saddle the subcontractor (and its surety) with a guarantee for both the prime contract and the subcontract. We hope that the SAUSD does not mean the subcontractor and its surety are the guarantors of the entire construction contract.

Indeed, I expect that whoever drafted these bonds forms on behalf of SAUSD did so with the intention of protecting both the District itself and the prime contractor from a default situation, with attendant failure of contract performance and unpaid subcontractors and suppliers. But the overall mechanism to affect this outcome and protect the Project, taxpayers, and laborers and suppliers is faulty. The solution is simple: SAUSD should require performance and payment bonds from the prime contractor, under which bonds SAUSD would be the obligee, and also require the prime contractor to obtain subcontractor performance and payment bonds, with the prime contractor as the sole obligee.

In addition to the faulty structure of the Performance Bond, a number of the terms and conditions substantially and inappropriately increase the risks to both the subcontractor and its surety. This increased risk will certainly affect the number of subcontractors that are able to submit bids for the Project. These bonds drafted so broadly, so vaguely, and so ambiguously that they will act as a significant deterrent to sureties who might otherwise wish to write bonds for the Project. NASBP provides below general commentary and comments on some of the specific terms and conditions that will elucidate our concerns and that we hope will be beneficial to you.

Section 1 requires the surety to respond to a written notice of default within fourteen days after the notice. This is an unreasonably shortened period of time for the surety to investigate, evaluate, and determine its response, even for a very small project. Bonds often require the surety to respond within 90 or 60 days; fourteen days is simply an unreasonably short period of time. In addition, section 1 provides that the surety must respond to a default under the

Agreement or the Subcontract, even though the bonded subcontractor is not a party to the Agreement between the prime contractor and the SAUSD.

Even in the highly unlikely event that any surety would write such bonds, it would be even more highly unlikely to yet again find a surety willing to write such bonds, as required in section 1(b). I reiterate that any surety that would risk writing such bonds would only do so for a highly capitalized, large subcontractor and that subcontractor would insert a large contingency into any such subcontract bid. In other words, with such onerous bonds, the California taxpayers would pay an unnecessary "premium" for the Project, even if sureties could be found to write such bonds.

Section 3 of the Performance Bond provides that the "District may reject any contractor or subcontractor proposed by the Surety . . . ." This section improperly limits the surety's completion options. Even were the SAUSD a proper obligee on the Performance Bond, which it most emphatically is not, this language is inappropriate. The section should provide that the prime contractor (not the District) could reject any subcontractor proposed by the surety and state that the prime contractor's acceptance of such a subcontractor proposed by the surety shall not be unreasonably withheld. 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 SAUSD Project.

Section 4 is particularly onerous and places a burdensome and improper obligation on the subcontractor and its surety. The Cost of Completion includes the "legal, design professional and delay costs resulting from the Surety's failure to timely perform its obligations under this Bond," which goes back to the unreasonably short fourteen-day response period imposed on the surety in section 1.

The language in section 7 is also troubling, as it provides that there is no limitation on the principal's liability. Furthermore, sureties object to the prevailing party language in section 9 because it potentially allows the obligee to perform an end-run around the penal sum limitation. 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. 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.

The language in section 11 appears to require waiver of any appeals right, with each party agreeing to "be bound by any judgment rendered thereby in connection with this Bond." One of the hallmarks of judicial proceedings is a right of appeal of an adverse judgment, and this section appears to eliminate that right.

The Payment Bond suffers from the same structural defect as the Performance Bond by providing that the subcontractor and the surety are bound to both the prime contractor and the SAUSD for payment for labor and materials. A subcontractor payment bond should bind the

bonded subcontractor and surety to the prime contractor only, as it is the prime contractor with whom the subcontractor has the contract.

The Payment Bond provides that the "sole condition of recovery" is that the claimant is a person described in the California Civil Code §§ 3110 and 3112 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 the Project.

Such onerous, non-industry standard bond requirements effectively preclude many highly qualified subcontractors from obtaining contract bonds, lowering bid and price competition on such projects significantly. These overly broad conditions place undue risk on the subcontractors. When contractors or subcontractors seek surety credit for contracts and bonds with onerous terms and conditions, sureties are much less likely to extend surety credit. The sureties will not issue such bonds, except to the very largest, most highly capitalized contractors and subcontractors. By including such onerous terms, the SAUSD is restricting competition and ensuring that the State pays more for the work. In addition, such policy does not comport with one of 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 serious reconsideration of the Performance Bond and Payment Bond for the Project providing that the SAUSD and the prime contractor are obligees on the bond. In addition, NASBP requests that you reconsider imposing such onerous bond terms and conditions on the subcontractors and their 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 consult and 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 subcontract performance protection 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