



## National Association of Surety Bond Producers

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October 4, 2011

Ms. Grindly Johnson  
Chief of Administration  
Virginia Department of Transportation (VDOT)  
1401 East Broad Street  
Richmond, VA 23219

Re: The review of performance and payment bonding requirements for transportation-related construction projects

Dear Ms. Johnson:

The National Association of Surety Bond Producers (NASBP), a national trade association of surety bond producers, including licensed resident and nonresident agents conducting business in Virginia, appreciates the opportunity to provide written comments to the Committee created by the Virginia Department of Transportation (VDOT) to review and to provide recommendations about the payment and performance bond threshold for Virginia transportation projects.

Our comments principally focus on significant issues that will arise as a result of dramatic increases to statutory payment and performance bond requirements. We note that such increase, from \$250,000 to \$500,000, is being contemplated for VDOT projects, similar to what was enacted under H.B. 1951, apparently for the purpose of assisting small and minority businesses to obtain public construction contracts as prime contractors. It is worth observing that the previous bonding threshold for VDOT project increased from \$100,000 to \$250,000 in 2006 presumably for the same or similar purpose. We are unaware of any study or of data that addresses the impact, if any, salutary or otherwise, that increasing the bonding threshold has had on increasing awards of prime contracts to small businesses. H.B. 1951 mandates the Secretary of Administration to report to the House Committee on General Laws and the Senate Committee on General Laws and Technology by December 31, 2012 concerning the impact the prequalification program has had on increasing awards to small and minority businesses. We anxiously await the results of the Secretary's report. We believe further increases to the bonding threshold are not only unwarranted but are, in fact, inapposite to the interests and protection of small construction firms.

### **The Absence of Payment Bonds Endangers the Viability of Small Businesses.**

By adopting statutory bonding requirements, the Virginia Legislature recognized the importance of having payment bonds in place to protect the downstream businesses that supply labor and materials on Virginia public construction projects. These business entities, the project subcontractors or suppliers, typically are small businesses whose only viable remedy in the event of nonpayment by the prime contractor is to claim on the payment bond.

In *Thomas Somerville Company v. L.R. Broyhill, et al.*, 200 Va. 358, 105 S.E.2d 824 (1958), the Virginia Supreme Court noted the inability of subcontractors and suppliers under Virginia law to place mechanic's

liens against Virginia public buildings and other improvements: “Materialmen and subcontractors who furnish supplies or work for the principal who has contracted with the public agency...for the construction of the public buildings and improvements are unable to perfect mechanic’s liens against the property for their protection.” The Virginia Supreme Court added that the bonding statute “is remedial in character, its language broad and inclusive, and obviously it was enacted to afford protection to materialmen and subcontractors.”

In lieu of a mechanic’s lien, subcontractors and suppliers have the ability to make claim on a statutorily-required payment bond. By raising the bonding threshold to \$500,000 on all transportation-related public construction contracts, however, many more materialmen and subcontractors in Virginia will be without payment protections. Having no recourse in the event of nonpayment is especially difficult for small businesses, as they typically do not have the cash flow or financial wherewithal to overcome payment defaults. Simply put, no payment bond in the event of a default may mean the extinction of their businesses and the jobs they created.

### **Surety Credit Relationships Help Small Construction Businesses Mature and Stay Viable.**

It is true that not every business can qualify for surety credit. If every business could qualify for surety credit, surety bond guarantees of performance and payment would be rendered illusory and meaningless. A surety extends credit as a result of an underwriting determination that the business being underwritten possesses the character, capacity, and capital to perform the bonded contract obligation. Bond producers work with construction businesses of all sizes to position them to achieve surety credit. They devote time and attention to these businesses, referring them to experienced consultants, such as construction attorneys and certified public accountants, who will provide them with direction and expertise that will assist the businesses to thrive in an exceedingly competitive industry. The surety also works with those businesses to which it extends credit to ensure that they have the resources to fulfill their contractual commitments and will even provide resources and expertise to prevent situations from developing into defaults, ensuring that these businesses stay viable. Surety relationships are invaluable to construction firms of all sizes as they compete. Surety credit relationships incentivize construction firms, including small firms, to take the steps necessary to mature as businesses. Raising the bonding threshold on public transportation projects conveys a different message, one that infers that construction businesses need not demonstrate their business discipline and their willingness to invest in their future.

### **Surety Bonding Requirements Assure that Qualified Companies Receive Award of Public Contracts.**

Raising the bonding threshold also may translate to an increase in construction firms that are incapable of obtaining bonding and that have not been through the surety’s comprehensive qualification process to receive award of public contracts for which no payment and performance bonds are required. As a public policy matter, only qualified construction firms should be given the opportunity to compete for construction contracts funded with public funds. Increasing the bonding threshold does not accomplish that goal.

### **Surety Underwriting Cannot be Approximated by Public Contracting Agencies.**

The Committee is contemplating establishing a qualification process, similar to what was adopted under H.B. 1951, for prospective contractors for contracts in excess of \$100,000 but not to exceed \$500,000. Contracting authorities would take on the task of qualifying contractors for such contracts. At present, the task of contractor prequalification is handled through the requirement of the bid bond, which would be removed as a result of the increased bond threshold. The bid bond assures that the contractor intends to enter into the contract at the price bid and will provide the required performance and payment bonds. If the contractor fails to do either, the bid bond specifies the amount to be paid as damages.

Sureties go to great lengths to underwrite and qualify construction companies. Professional prequalification, as done by a surety, involves both qualitative and quantitative analyses of a construction firm in order to gain a complete picture of the contractor's qualifications. Sureties carefully scrutinize each contractor's financial soundness, experience, and qualifications, to ensure that the contractor can meet its payment obligations and perform its construction contracts. NASBP believes that such a depth of understanding is not one that can be or should be approximated by a public contracting authority. Few, if any, public contracting agencies are well prepared to perform rigorous contractor prequalification. Public contracting agencies have limited resources and expertise with respect to analyzing the qualifications of contractors. State and local contracting authorities should not assume this burden when it already is being done successfully and more efficiently by sureties, which are in the regular business of qualifying construction firms. Realistically, state and local contracting agencies will have to augment their workforces and commit additional resources to perform qualification of construction firms. Sureties play an active role in ensuring that bonded contractors are taking all the necessary steps to fulfill obligations. Such assistance may include providing advice on internal controls, key management decisions, and offering professional references, such as accountants and engineers, while meeting with their contractors on a regular basis for progress reports. Will the contracting authority perform these functions?

### **Public Contracting Agencies Are in the Business of Procuring Goods and Services, Not Administering Claims.**

Just as in any business endeavor, some contract defaults will occur. Are contracting agencies prepared to act as claims administrators? Administering surety claims likely is a considerable departure from the usual duties of local and state contracting agencies. How would they handle such a process?

Questions for the Committee to consider: 1) would this resource pool be protected and placed in a "lock box" so that the funds are not absorbed into the general fund during periods of strict budgetary constraints?; 2) what might happen if there was a major project failure and the resource pool could not adequately handle all of the claims; would the burden of paying those claims then be shifted to the taxpayers of the Commonwealth or would those businesses suffering losses simply go unpaid?; and 3) is the purpose of the Commonwealth to be in the regular business of administering and paying claims?

### **Recommendations for VDOT to Consider as Alternatives to a Bonding Threshold Increase.**

NASBP believes the following recommendations would provide direct assistance to small and minority construction firms:

- Standing programs to provide small construction firms with the education and technical assistance needed to mature as viable, successful businesses are important and needed.
- VDOT should consider assistance and grant programs to ensure that the owners/managers of small construction firms have firm grounding in business, financial, and risk management practices.
- VDOT could establish a standing curriculum of coursework/workshops for these business managers to obtain specific training and to receive a certificate of completion from VDOT.
- VDOT could work with industry and local groups for curriculum development and instruction. The Surety & Fidelity Association of America (SFAA) Model Contractor Development Program could furnish a useful model or baseline.
- VDOT could work with the local surety, legal and accounting communities to develop resource/referral network.
- The Office of Surety Guarantees of the U.S. Small Business Administration offers a bond guarantee program aimed at providing bonds to small and emerging construction businesses.

- The Office of Small and Disadvantaged Business Utilization of the U.S. Department of Transportation offers lending and other programs specifically designed to benefit small and emerging contractors seeking to perform transportation contracts.

**Final Points**

The Commonwealth of Virginia should not be seeking to deprive Virginia businesses and taxpayers of payment and performance protections in this difficult economic environment. If the impetus behind increasing the payment and performance bond threshold is for greater inclusion of small and minority businesses as prime contractors on state contracts, better approaches exist that do not involve stripping subcontractors and suppliers, many of them being small businesses, and taxpayers of needed protections.

The construction and surety industries have existing programs to mentor and educate small and minority businesses so they are positioned for long-term success as businesses, including enhancing their standing to obtain financial and surety credit. Such programs could be put in place quickly. Removing needed protections and transferring the risk of losses to taxpayers is an imprudent, if not a dangerous, measure. Increasing the performance and payment bond threshold does not exhibit sound public policy nor does it serve the interests of the Commonwealth of Virginia, its taxpayers, or its many businesses performing as subcontractors and suppliers on public construction projects.

Please feel free to contact me if you have any questions or need additional explanation with any of the points that were raised.

Sincerely yours,



Larry LeClair  
Director, Government Relations