



National Association of Surety Bond Producers

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Senator Walter Timilty
Chair, Senate State Administration &
Regulatory Oversight
State House
Room 213-B
Boston, MA 02133

Representative Peter V. Kocot
Chair, House State Administration & Regulatory
Oversight
State House
Room 22
Boston, MA 02133

RE: Strong Opposition to H.1702/1703, An Act relative to default insurance programs for certain public construction projects. Please consider an unfavorable vote.

Dear Chairmen Timilty and Kocot:

On behalf of the National Association of Surety Bond Producers (NASBP) a national trade association representing firms employing surety bond producers, including licensed resident and non-resident agents placing contract surety bonds in the Commonwealth of Massachusetts, we strongly oppose H.1702/1703, legislation that amends paragraph two of Section 8(a) of Chapter 149A of the Massachusetts General Laws by allowing construction managers at risk (CM@R) to use a subcontractor default insurance (SDI) policy in lieu of the otherwise required performance and payment bonds from trade contractors. In addition, NASBP opposes H.1702/1703 because, unlike performance and payment bonds, which benefit both the owner and the trade contractors, SDI does not benefit either the owner or unpaid trade contractors. Rather it only benefits the CM@R, which seeks through SDI to retain more of its fee.

The Importance of Surety Bonds

Corporate surety bonds are three-party contract agreements by which one party (a surety company) guarantees or promises a second party (the obligee/government) the successful performance of an obligation by a third party (the principal/contractor). The bid bond assures that the bid has been submitted in good faith and the contractor will enter into the contract at the bid price and provide the required performance and payment bonds. A performance bond protects the project owner (the Commonwealth of MA) and the taxpayers from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. The payment bond protects subcontractors and suppliers, which do not have direct contractual agreements with the public owner and which would be unable to recover lost wages or expenses should the contractor be unable to pay its financial obligations.

The Massachusetts Legislature recognized the importance of surety bonds by enacting Title XXI, Labor and Industries, Chapter 149, Labor and Industries, Section 29 "Contractors' Bonds on Public Works." Moreover, in 2004 the Legislature enacted an enabling statute for alternative project delivery, CM@R, and required performance and payment bonds from all trade contractors, in recognition of the importance of protecting the financial integrity of public projects and downstream businesses that supply labor and materials on Massachusetts public construction projects.

Surety v. SDI

SDI is a catastrophic insurance policy that provides coverage to the general contractor or CM@R for the direct and indirect costs of trade contractor default. Unlike surety bonds, which provide first-dollar

coverage, SDI has a high deductible and co-pay requirements, requiring the CM@R to self-finance a significant portion of the trade contractor risk of default. In at least one notable instance, use of SDI--and self-retention--caused a contractor/CM@R to default.

Furthermore, with SDI, the prime contractor/CM@R, not the surety underwriter, prequalifies the trade contractors. A CM@R receiving confidential financial and other such data may on future projects act as a competitor of the very trade contractor whose confidential information it received for purposes of enrollment in a SDI. Thus, trade contractors view the SDI prequalification process as invasive and an administrative burden. As a result, trade contractors prefer prequalification from an independent third party, a surety company, as this process addresses their privacy and administrative burden concerns.

In deciding to grant surety credit, the surety underwriter conducts in-depth analysis, of the capital, capacity and character of the construction firm during the underwriting process to determine the contractor's ability to fulfill contractual commitments. Surety bonds are an essential means to discern qualified construction companies and to guarantee contracts and payments, ensuring that vital public projects are completed, subcontracting entities are paid, and jobs are preserved. In addition, the surety-trade contractor relationship extends well beyond one project; it may span decades. Because of this long-term relationship, sureties have access to performance and financial data not readily available to the contractor.

H.1702/1703 —Its Impact on Trade Contractors & Small Businesses

SDI does not have any payment protections for trade contractors and their subcontractors and suppliers; SDI only benefits the CM@R. Accordingly, unlike payment bonds, SDI has no payment protection for those smaller construction entities, often minority and disadvantaged business enterprises, that can ill-afford to have payment protection eliminated for their work performed on a project. If they are left unpaid by a trade contractor, they must seek recourse further upstream, the CM@R, increasing the cost of trying to obtain a remedy. In addition, under SDI trade contractors have no protection from an arbitrary or unwarranted default declaration by the CM@R. The insurer that issues the SDI, having paid the CM@R and being subrogated to its rights, will seek recovery from the trade contractor, impeding its ability to obtain more work.

Finally, H.1702/1703 would jeopardize small business entities that may be left without a remedy against the CM@R payment bond in the event of nonpayment. If trade contractor payment bonds are in place, they provide more layers of protection and a greater pool for recovery for smaller, often minority and disadvantaged, subcontractors and suppliers. If the CM@R becomes insolvent or just refuses to pay, an enrolled subcontractor has no recourse against the SDI.

H.1702/1703 – Its Impact on small and mid-size Construction Managers

SDI is only available to the largest CM@R; those, for example, having in excess of \$100,000,000 of subcontractor costs. This is a small number of firms in the Commonwealth. Many other contractors who would also bid as CM@R will be at a cost disadvantage. CM@R view SDI, much as they do with Contractor Controlled Insurance Programs (Wrap-Ups), as a profit center, thus reducing their costs on projects and enabling them to have a cost advantage over those who cannot procure SDI.

H.1702/1703 —Its Impact on the Commonwealth of Massachusetts

Use of SDI on state-funded projects could pose legal concerns/liability regarding the Massachusetts False Claims Act (MFCA). With SDI, the CM@R typically charges the owner (government) more than its direct cost paid to the insurer for program coverage. If this situation was to occur, a violation of MFCA may happen.

Legal Concerns to Consider

Almost all sureties require personal and corporate indemnity. Assets of the firm and the personal assets of company ownership are pledged to the surety as a precondition of surety credit. Thus, the indemnity arrangement provides incentive to construction executives to resolve project problems, an incentive that is less likely to be present with the use of SDI. While there is a long history of legal precedence concerning the terms and conditions of performance and payment bonds, there have been few, if any, legal decisions regarding a policy dispute between a contractor/CM@R and the insurer. This lack of legal certainty regarding enforcement of policy terms and conditions increases the risk of use of SDI.

For these reasons, NASBP recommends that you cast an “unfavorable” vote on H.1702/1703. This legislation will place an unfair disadvantage on construction trades, small and mid-size businesses and may cause potential harm to the taxpayers of the Commonwealth of Massachusetts. Please feel free to contact me should you have further questions.

Respectively submitted for your consideration,

A handwritten signature in black ink, reading "Larry LeClair". The signature is written in a cursive, flowing style.

Larry LeClair
Director, Government Relations

cc: Members of the Joint Committee on State Administration & Regulatory Oversight
Michael Regan, NASBP Past Regional Director, Regan Clearly Insurance LLC, Boston, MA
William Delaney, Delaney Legislative Services, Inc., Boston, MA