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BY ELECTRONIC TRANSMISSION (schuh@nku.edu; bairde1@nku.edu) AND U.S. MAIL

May 9, 2013

Ms. Mary Paula Schuh
Director, Office of Campus and Space Planning
Northern Kentucky University
Lucas Administrative Center, 726
Nunn Drive
Highland Heights, KY 41099

Mr. Eli Baird
Procurement Services, Bid Specialist
Northern Kentucky University
Lucas Administrative Center, 617
Nunn Drive
Highland Heights, KY 41099

Re: Problematic Terms in NKU Construction Management Services Agreement

Dear Ms. Schuh and Mr. Baird:

The National Association of Surety Bond Producers ("NASBP") is a national trade association of professional surety bond producers, representing firms employing licensed resident and nonresident producers placing surety bonds on contracts in the Commonwealth of Kentucky and in other jurisdictions. A proposal solicitation involving construction management services for a campus recreation center project at Northern Kentucky University recently has been brought to our attention. More specifically, Article 36 – Performance and Payment Bonds of the NKU Construction Management Services General Conditions document contains problematic language addressing (1) the amount of the performance bond required on the construction manager and (2) the need for a countersignature by a "licensed resident agent." In both instances, we believe these requirements to be contrary to Kentucky law and inapposite to the best interests of Northern Kentucky University.

Kentucky Revised Statutes Chapter 45A applies to construction of capital projects, including those carried out by institutions of higher learning, undertaken with the expenditure of public funds by the Commonwealth. KRS 45A.190 provides that, when a construction contract exceeds $40,000, a performance and payment bond equivalent to 100% of the contract price must be furnished. KRS 45A.030(6) defines the term "construction management-at-risk" and establishes that contracts utilizing that delivery method are subject to "the bonding requirements of KRS 45A.190." Clearly, a requirement of a performance bond in 100% of the contract price is the applicable law in situations involving CM-at-risk arrangements. However, the performance bond requirement in the NKU Construction Management Services General Conditions document, Article 36, states: "The Construction Manager shall furnish a Performance Bond in the form provided in the Contract Documents in the full amount of the Contract Amount less the amount bonded by the individual Trade Contractors as security for the faithful performance of the Contract." This does not comply with the dictates of KRS 45A.190. To do so, the construction manager must furnish the contracting entity with a performance bond for 100% of the

“Contract Amount.” Reducing the performance bond amount by the amounts bonded by the individual “Trade Contractors” is not equivalent to a performance bond in 100% of the contract price of the work being contractually undertaken by the construction management firm. Interestingly, and fortunately, a similar requirement is not imposed on the payment bond; the language addressing the “Payment Bond” does not require a reduction in the amount of the payment bond by the bond amounts of the individual trade contractors.

It should be noted that a performance bond from the construction manager to the contracting entity in less than 100% of the contract amount does not provide full protection to the contracting entity, even if the contracting entity has the status of a dual obligee on the performance bonds provided by the trade contractors to the construction manager. For example, when the construction manager provides a performance bond in 100% of the contract price, in the event of a default by that construction manager, the contracting entity has the ability to claim up to the full amount of the bond, which represents the original, full price of the contract, to rectify the costs of the default. The contracting entity also need only work with one surety to address its claim.

This is not the case in the situation presently described in Article 36. The performance bond furnished by the construction manager is reduced by the amounts of the bonds furnished by trade contractors. This is likely to be a substantial reduction in the amount of the bond provided by the construction manager and many times less than the amount of the original contract price of the work. In the event of a default by the construction manager, the contracting entity could only recover up to the face amount of the construction manager’s bond; the performance bonds of the trade contractors would not be implicated if the material breach solely arises from the actions or inactions of the construction manager.

For example, if the contract amount to the construction manager is $50 million and the construction manager does not self-perform any of the work, the construction manager would subcontract probably 90% of that amount or $45 million and only have to provide a $5 million performance bond to guarantee the performance of the construction manager’s work. Assume that the construction manager starts having problems on the job, makes bad scheduling decisions, incurs delays to the work, and then closes its doors and files bankruptcy. Next, all the subcontractors walk off the job and terminate their subcontracts because they have not been paid, despite the Owner paying the construction manager. To complete the project, new subcontractors will have to be hired (at a premium price) to complete the subcontract work. Errors in the work would have to be corrected. Delay costs, acceleration costs, price escalations, extended overhead costs will have to be addressed before work restarts. Further, another construction manager will need to be retained to clean up the mess and complete the project. The costs associated with the default of the construction manager, say, are $12 million but the construction manager’s performance bond is only for $5 million. While the Owner has the performance bonds of the subcontractors, the subcontractors did not do anything wrong and properly terminated after the construction manager quit paying them, breaching the subcontracts. So the Owner does not have access to the subcontractors’ performance bonds. Consequently, the Owner will get $5 million from the construction manager’s performance bond surety company but the additional $7 million in costs associated with the original construction manager’s default will have to be paid by the Owner. Had the Owner received a performance bond from the construction manager in the amount of 100% of the contract amount, the $12 million would be taken care of by the surety company bonding the construction manager.

It also is worth noting that, in a situation with multi-party defaults by the construction manager and trade contractors, the contracting entity faces the increased legal, administrative, and resource burden of proceeding on claims against multiple sureties. From statutory and common-sense standpoints, the current performance bond requirement is, at best, ill-advised and will leave you less protected.

The resident agent countersignature requirement also is troubling. Resident agent countersignature requirements have been eliminated throughout the United States, through acts of state legislatures or though judicial decisions declaring them unconstitutional. Such courts have found statutes mandating that only resident agents can countersign policies to discriminate unlawfully against licensed non-resident agents, violating their rights under the Privileges and Immunities Clause and the Equal Protection Clause of the U.S. Constitution. Please consult, for example, *Council of Insurance Agents & Brokers v. Tom Gallagher*, in which a federal district court declared Florida's statute unconstitutional, and *Council of Insurance Agents v. Molasky-Arman*, in which a federal district court declared Nevada's statute unconstitutional. For these reasons, we were surprised to see a resident agent countersignature requirement in the solicitation materials. However, a requirement for a countersignature from a licensed agent, whether resident or nonresident, would not violate constitutional protections.

We respectfully request your immediate review and consideration of our concerns. Please do not hesitate to contact me should you have any questions concerning this letter.

Yours sincerely,

Mark H. McCallum
Chief Executive Officer