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BY ELECTRONIC TRANSMISSION (robert.wiseman@uky.edu) AND U.S. MAIL

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Robert Wiseman, Vice President for Facilities Management
University of Kentucky
225 Peterson Service Building
Lexington, KY 40506-0005

RE: NASBP Concerns on Bonding Requirements for Project # MC 6314 Roach Basement Linear Accelerator Room Renovation (CCK-1887-14)

Dear Mr. Wiseman:

I am contacting you on behalf of the National Association of Surety Bond Producers (NASBP), a national trade association of companies employing licensed surety bond producers, including those resident and non-resident in the Commonwealth of Kentucky. We were recently forwarded a copy of the Performance Bond and the Payment Bond relating to the University of Kentucky (UK) Project # MC 6314 Roach Basement Linear Accelerator Room Renovation (CCK-1887-14) (UK Project). We have reviewed these bonds, and the terms and conditions of these bonds give NASBP cause for concern. More specifically, we believe that these bond terms and conditions are counter to prevailing surety industry practices and to the market reputation of UK as a desirable procurer of construction services. We provide below certain insights that will elucidate our concerns and that we hope will be beneficial to you.

Our general concern about these bonds is that they are drafted so broadly, so vaguely, and so ambiguously that they may act as significant deterrents to sureties wishing to write these bonds. These bonds could limit the broad competition that UK, no doubt, desires on such a public project. Indeed, the language in these bonds, in essence, turns the surety into a liability insurer for the project, ignoring fundamental distinctions between surety bonds and insurance policies.

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 a 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, spreading 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 and to pay subcontractors and suppliers and are not acting as insurers for the project.

Both the Performance Bond and the Payment Bond contain lengthy limitations periods that are not standard in the industry. The effective period for each bond is "limited only by statutes of limitation" and, if the broad obligations in each bond are not performed, the bond "shall remain in full force and effect." In Kentucky, the statute of limitations for bringing an action against a surety bond is seven years after the cause of action accrues. Ky. Rev. Stat. Ann. § 413.220(3). This limitations period is unpalatable for sureties and is likely to restrict those sureties willing to issue such bonds. In addition, even those sureties who might issue such bonds would likely charge a premium that the owner would find unpalatable. Performance and payment bonds typically have a one- or two-year limitations period, and NASBP recommends that such a limitations period more typical in the industry be stated in the Performance Bond and the Payment Bond for the UK Project.

The conditions of the Payment Bond are overly broad, and some of the enumerated items for claims are not customarily recoverable under payment bonds. For instance, insurance, which is listed as recoverable, is considered neither labor nor materials; and insurance costs should not be delineated as recoverable under the Payment Bond. It is also not customary and usual for taxes and contributions required by law to be withheld and paid during the warranty periods to be recoverable under payment bonds.

In addition, the Payment Bond provides that "the PRINCIPAL and the SURETY agree that this bond shall insure [sic] to the benefit of all persons having just claims as aforesaid, whether or not they have any direct contractual relationship with the PRINCIPAL, as well as to the benefit of the OWNER . . . ." This language is problematic on a number of fronts. The typographical error in the Bond of "insure" for "inure" is ironic, as the bond language does indeed seem to "insure" rather than "inure" to the benefit of all persons. There is no defined limit on who can be a claimant, as the language provides that "all persons having just claims" have the benefit of the bond protection. The Payment Bond has no statement of the specific tiers of subcontractors and/or suppliers that are proper claimants under the Bond. In short, such language suggests that almost anyone could be considered a claimant for purposes of making a claim on the Payment Bond. For instance, the broad language suggests that the owner's project manager and the owner's architect, both of whom provide "services" on projects, could make a claim on the contractor's Payment Bond. Such claimants are not the intended beneficiaries of payment bonds.

This unlimited class of claimants could be a significant deterrent for contractors wishing to bid on the UK Project, as they have to pay back to the surety any amounts that the surety must pay as a result of having issued the bonds. Interestingly, the class of claimants in the Payment Bond is much broader that that required under the Kentucky Revised Statutes, which states that the statutory payment bond on public projects provides coverage for laborers and materialmen providing labor and material to the principal and its subcontractors that are necessary for the performance of the work under the principal's contract. Ky. Rev. Stat. Ann. § 45A.190(2)(b). In short, the class of claimants under the statutory bond is limited to first- and second-tier claimants, a typical definition of "claimants" under payment bonds.

Significantly, the Owner is specifically--and improperly--included as a beneficiary under the Bond, which does not comport with the purpose of a payment bond. Payment bonds are for the direct benefit of certain classes of laborers and suppliers, not for the direct benefit of owners. Owners do indirectly benefit from payment bonds, as it is in the owners' interests for laborers and suppliers to get paid on projects. Owners themselves, however, do not have claims upon payment bonds; owners' claims are upon performance bonds.

Furthermore, the Payment Bond and the Performance Bond stipulate that each automatically increases with each increase in the contract amount or time, with no limitation on the amount of the increase or any other scope changes. Such a provision could well mean that a surety ends up having bonded a project for which it did not assume the particular risks. The premiums that are paid to a surety are not predicated on the face amount of bonds; rather, sureties calculate their premium rates on the contract price, which they believe constitutes their risk. In short, such bond language is inappropriate and would serve as a disincentive for sureties to write such bonds.

The Performance Bond is deficient in other ways. It is usual and customary that the surety's responsibility under a performance bond is based on the default of the contractor/principal in failing to properly perform the contract. The Performance Bond, however, is written much more broadly and could be interpreted to include other claims against the contractor, such as personal injury, which is an insurance, not a surety, risk. The condition provides that "the PRINCIPAL shall satisfy all claims and demands incurred under such contract, and shall fully indemnify and save harmless the OWNER from all costs and damages which it may suffer by reason of failure to do so . . . ." This condition is so broad and so vague that it invites significant disputes and litigation.

Additionally, the Performance Bond contains language suggesting that the total aggregate penal sum of the bond is not a true penal sum: the bond provides that the surety's obligation is to "fully indemnify and save harmless the OWNER from all costs and damages which it may suffer by reason of failure to do so, including attorneys' and consultants' fees, and shall reimburse and repay the OWNER all outlay and expense which the OWNER without limitation, may incur in making good any default . . . ." The inclusion of the phrase "without limitation" suggests that the penal sum of the bond is without limitation, a condition for which the surety is unable to assess the risk. The condition should clarify that the surety's total liability is up to the penal sum of the bond. The Payment Bond should have a clear and unambiguous penal sum; otherwise, the surety cannot assess its risk in issuing the bond.

We firmly believe that the Payment Bond and the Performance Bond, which have been drafted more akin to an insurance policy than a surety bond, could chill surety participation in the process, an undesirable result on this important public project. We also firmly believe that UK could maximize competition and enhance its reputation as a responsible and desirable project owner by making sure the bond forms on the UK Project conform with familiar and accepted industry practices.

We respectfully request that the UK Capital Construction Procurement Section reconsider the terms and conditions of its performance bond and payment bond associated with the UK Project, deferring to existing statutory bond language. 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 issues. 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 tested in the court system.

We appreciate your prompt consideration of our concerns. If you have issues on which you would like feedback, we would be glad to assist you and respond to those issues. We would also be happy to work with you to craft bond language that will properly provide contract performance protection to UK, as owner, and payment protection to certain laborers and suppliers. Please feel free to contact me should you wish to discuss these matters further.

Yours sincerely,

Martha L. Perkins

Martha L. Perkins
General Counsel

cc: Mark H. McCallum, CEO