



SB 234--Increasing State Bond Thresholds....It Hurts Small and Emerging Contractors and Puts State Taxpayers and Laborers at Risk

Background—Public Works Performance and Payment Bond Requirements

There is good public policy for the universal requirement of surety bonds on public works projects. These bonds guaranty that the project will be completed and that subcontractors, suppliers and laborers on the project get paid. If the surety backs a contractor that defaults on the project, the full amount of the surety bond is available to complete the work and pay those who performed work on the job. Congress, all states and many municipalities recognize the value of these bonds.

The Federal Miller Act

In 1894, Congress enacted the Heard Act to codify the existing practice of requiring public works contractors to furnish a bond to assure completion of the contract work and payment of subcontractors and suppliers. In 1935, the Miller Act replaced the Heard Act and required separate performance and payment bonds. The minimum amount below which bonds are not required, the "bond threshold," was set at \$2,000 in 1935 and raised to \$25,000 in 1978. In 1994, the federal law was amended to raise the threshold to \$100,000 but to require payment security for the protection of subcontractors and suppliers on contracts between \$25,000 and \$100,000. The Miller Act was reviewed again in 1999 and the amount of protection under the payment bond was increased to 100% of the contract price. Not only did Congress decide not to increase the threshold below which bonds are not required, the final regulations provided that a payment bond is the preferred type of payment security for contracts between \$25,000 and \$100,000.

State Bonding Requirements on Public Projects

All 50 states and the District of Columbia require surety bonds on state and local public works projects. The state bond thresholds vary. The majority of states have thresholds of \$50,000 or less. The federal government ameliorates the adverse impact of even a \$100,000 threshold by requiring alternative payment protection on contracts between \$25,000 and \$100,000. Some states have moved to the \$100,000 threshold of the federal government, but in only a few states does the state bond threshold exceed \$100,000.

The Impact of Increasing State Bond Thresholds

- **Many Small Subcontractors Are Left with Far Less Protection--**Mechanics liens cannot be asserted against public property. Laborers, subcontractors and suppliers on public projects must rely on the general contractor's payment bond for protection. If no bond is required, these parties are left with no means to collect for their services and supplies if the contractor is unable or

unwilling to pay them. Small, emerging and minority contractors are more likely to start as subcontractors. This is especially true on smaller projects, and the most vulnerable companies will be the ones deprived of payment protection by this bill. If the bond threshold is raised, such subcontractors and suppliers will either have to risk losses from non-payment that they cannot afford or not work on the public jobs for which they are best qualified.

Experience shows that contractors become bankrupt and otherwise default on projects. According to BIZ Miner, of 823,830 building, heavy/highway, and specialty trade contractors operating in 2000, only 589,850 were still in business by 2002, amounting to a 28.4 % failure rate. The number of construction surety claims incurred also reflects the inherent risk of construction. It does not take much imagination to realize that with a high bond threshold, a contractor could bid on and be awarded multiple large state contracts for which no payment and performance bond would be required, and easily could have a significant amount of unbonded construction underway when financial problems force the contractor into bankruptcy. When a contractor goes bankrupt, they do not fail on one project, but on all.

● **Exempting Small Contractors from Bonding Requirements Inhibits Their Growth and Financial Stability**--To grow in the arena of public construction, a contractor needs an established relationship with a surety. Increasing the level at which the contractor is first required to seek bonding delays the inevitable bonding requirement if the contractor wants to expand. The later the small contractor is required to enter the bonding world, the harder it will be to gear its business to meet the underwriting standards put in place to ensure only qualified contractors are bonded to complete state projects. These standards also help to ensure the contractor is taking the steps necessary to manage its business correctly and efficiently. In the long run, raising bond thresholds harms small and emerging contractors and suppliers by substantially increasing their risk of non-payment if they are operating as subcontractors and by raising the difficulty of qualifying for their first bonds.

● **Increasing the Bond Thresholds Puts Taxpayers at Greater Risk**--The performance bond ensures that the project is completed for the contract price. If a performance bond is not provided, the taxpayers take on the risk that the contractor will default. By raising the bond threshold, there will be more contracts on which state and local jurisdictions will bear the burden of re-letting work and paying any excess completion costs.

● **State and Local Jurisdictions Will Need to Screen and Qualify More Contractors**--Lastly, but no less important, is the qualification process that the surety puts the contractor through to ensure the contractor is qualified to complete the contract. The surety examines the contractor's expertise in the work, character, ability to work in the region where the project is located, current work in progress, and overall management as well as its capital and financial record in paying its obligations. A public entity is not going to have the time, or access to the information needed, to make such a detailed evaluation of each bidder. Further, leaving this to the government puts the State at risk of claims of cronyism and fraud.

● **Increasing the Bond Threshold May Not Achieve its Intended Goal of Advancing Small and Emerging Contractors**; Increasing the bond threshold does not necessarily mean that small and emerging contractors will obtain more state construction business, but rather that all contractors will be able to bid on much larger state projects without being required to provide payment and performance bonds. The result of increasing the bond threshold may be that financially unstable contractors in the state and from surrounding states who cannot obtain bonding and are not pre-

qualified by sureties will be bidding and obtaining construction projects.

Consider the Consequences of Unbonded Projects:

News articles describing the consequences of unbonded projects are attached. In addition, there are numerous cases in which unpaid subcontractors and suppliers have been left unpaid by the government's failure to obtain statutorily required bonds. See, for example, *U.S. Dept. of the Army v. Blue Fox, Inc.*, 525 U.S. 255, 119 S. Ct. 687, 142 L. Ed.2d 718 (1999); *N.V. Heathorn, Inc. v. County of San Mateo*, 2005 WL 419462 (Cal. App. February 23, 2005); and *Electrical Electronic Control, Inc. v. Los Angeles Unified School District*, 24 Cal. Rptr.3d 316 (Cal. App. 2005).

Conclusion

For the reasons listed above, increasing state bond thresholds is contrary to sound public policy and should be vigorously opposed. Bonding requirements exist to provide vital safeguards for those who work on public projects and the taxpayers who pay for them.

A program currently is in place in Ohio to assist small and emerging contractors in obtaining surety bonds. The surety industry was instrumental in the development and implementation of the creation of the Encouraging Diversity Growth and Equity (EDGE) Bond Guarantee Program, which is designed to encourage surety companies to increase bonding activity with Ohio's economically and socially disadvantaged business enterprises. The program enables the Ohio Department of Development (ODOD) to guarantee up to 90% of losses incurred and paid by a participating surety if an eligible business defaults on any bid, performance or payment bond issued by the surety. In addition, as part of the program, participating contractors must attend a series of educational workshops related to improving their company's potential bondability in the traditional (non-guarantee) bond market. These workshops were developed by The Surety & Fidelity Association of America (SFAA) and the State.

The State Controlling Board also approved creation of the program by releasing \$2,235,000 to provide \$745,000 to three companies that will participate as sureties in the program, including CNA Surety Corporation, Great American Insurance Company and the Ohio Casualty Insurance Company. Businesses eligible for participation in the EDGE Bond Guarantee Program must receive EDGE certification through the Ohio Department of Administrative Services. The state's EDGE program establishes goals for state agencies in awarding contracts to socially and economically disadvantaged businesses that are certified under the program.

The relationship between a surety and its client is one of mutual help. The surety wants the contractor to succeed and grow, and the surety prospers only when the contractor succeeds. SFAA and its members and the surety industry are committed to assisting small and emerging contractors to increase their bondability.