

Ohio HB 1—The State Budget 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 guarantee 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.

Ohio HB 1 would allow the Director of Development to waive the protections of bonding for minority contractors for the first five public projects that a minority contractor is awarded. Upon the successful completion of a \$25,000 construction project without bonding, the contractor can obtain a \$50,000 contract without providing the bonds required by law. The third contract, at \$100,000, doubles the amount from the second project without bonding. The fourth contract triples the amount of work that can be done without bonding to \$300,000 and the fifth public project doubles that amount to permit a \$600,000 project to go forward without the protections for workers and state taxpayers that bonding provides.

For the reasons set forth below, the bond waivers in HB 1 could actually harm rather than help small and emerging contractors and should be stricken from the bill.

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 emerging contractors are more likely to start as subcontractors. This is especially true on smaller projects, so that the most vulnerable contractors will be the ones deprived of payment protection by Ohio HB 1. 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 in order to avoid the increased risk of non-payment.

Experience shows that contractors become bankrupt and otherwise default on projects. According to BIZ Miner, of the 850,029 building (non-single-family), heavy/highway, industrial buildings/warehouses, hotel/motel and multifamily home construction, and specialty trade contractors operating in 2004, only 649,602 were still in business in 2006—a 23.6% failure rate. Construction companies that have been in business less than one year had an even higher failure

rate – 36.8%. The number of construction surety claims incurred also reflects the inherent risk of construction. In the current economy, there is all the more risk for contractors in general. The protection of a payment bond is needed all the more to assure that the small and emerging contractors will be paid. Contractors operate on thin profits margins. Not getting paid on their last job can be the difference between success and the failure of their business.

● **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 not getting paid if they are operating as subcontractors and by raising the difficulty of qualifying for their first bonds in order to become a general contractor.

● **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**-- For the projects for which Ohio HB 1 would allow bonds to be waived, the State and other public entities still will want to use only contractors that can complete the work on time and according to the terms of the contract. If bonds are waived, public contracting officers will not have the benefit of the qualification process that the surety puts the contractor through to ensure that the contractor can do the job. 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 will not 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 Ohio at risk of claims of cronyism and fraud, which the independent, third-party process of the surety is designed to prevent.

● **HB 1 Would Give Ohio the Largest State Bond Threshold in the Nation**

Under the federal Miller Act, Congress requires a payment and performance bond for 100% of the contract price for projects in excess of \$100,000. In addition, the federal law requires "payment security" for all contracts between \$30,000 and \$100,000. A surety bond is one of the options for providing such payment security. All 50 states and the District of Columbia require surety bonds on state and local public works projects. The state bond thresholds vary, but most of the states have thresholds of \$50,000 or less. If the federal government protects small and emerging contractors at \$100,000, can Ohio afford to do any less for them on state projects?

● **Sureties Already are Actively Assisting Small and Emerging Contractors in Ohio**

The Surety & Fidelity Association of America (SFAA) and its members have implemented SFAA's Model Contractor Development Program (MCDP) to assist small and emerging contractors in Ohio to become bondable. The MCDP consists of two interrelated components—educational workshops

and bond readiness. There are ten educational workshops, each of which is designed to provide information to the contractors related to improving their company's operations. This will make it easier to be bonded or to increase their bonding capacity and help contractors access bonding and technical assistance tailored to fit their needs. The bond readiness component consists of one-on-one interactions for the contractor with surety bond producers, underwriters and other professionals who work with the contractors on a case-by-case basis in assembling the materials necessary for a complete bond application and in addressing any omissions and/or deficiencies that might deter the successful underwriting of a bond.

Under an April 2008 Memorandum of Understanding (MOU), SFAA launched a MCDP in Cleveland, co-sponsored by the Greater Cleveland Partnership, which is that city's local Chamber of Commerce. The Cleveland Bonding Prep Program began workshops in April 2008. Those contractors who successfully completed the workshop phase of the program (15 out of 17) were set up with mentors, including the Surety Association of Ohio members, bond agents, contractors and others. Currently, these mentors are involved in developing and implementing prescriptive plans for the contractors under the Bond Readiness component of the Program and several of the contractors already have been successfully bonded.

SFAA, in concert with local partners--Cincinnati Minority Contractors Business Assistance Program (Cincinnati MCBAP) and Allied Construction Industries, Inc.(ACI)-- implemented the educational component of the MCDP entitled "From the Banks to the Bridges" in Cincinnati in November 2008. The bond readiness portion of the MCDP continues as local members of the Surety Association of Ohio assist individual participants with bond applications. This program began with an MOU in August 2008 and is being sponsored by Great American Insurance Group's Bond Division, Schiff, Kreidler-Shell, Inc., and Messer Construction Company.

Sureties want contractors to succeed and grow, and the sureties prosper only when the contractors succeed. SFAA and its members and the surety industry are committed to assisting small and emerging contractors to increase their bondability.

● **A System to Provide Bond Guarantees Has Been Enacted in Ohio**

The Director of Development in Ohio has the authority to write bonds for minority businesses under Section 122.80 of the Ohio Revised Statutes. That authority is operational.

Another program currently is in place in Ohio to assist small and emerging contractors in obtaining surety bonds. The surety industry was instrumental in 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 surety bond market.

The EDGE program, however, has never been fully implemented because the funding and other resources needed are among the many competing interests for limited state funding. The EDGE program has been able to provide some technical assistance to small and emerging contractors seeking bonding, but currently does not have the resources to issue bond guarantees.

Consider the Consequences of Unbonded Projects:

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. There are other alternatives to bond waivers in Ohio that are already in place that are working or that could be improved to work to solve any bonding problems for small and emerging contractors.