THE SURETY & FIDELITY ASSOCIATION OF AMERICA

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Business Challenges within the Defense Industry

"Doing Business with DOD: Unique Challenges Faced by Small and Midsize Businesses"

The Surety & Fidelity Association of America
Serving the Industry Since 1908

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Thank you for inviting us here today to testify on a matter that is critical to the surety industry, to the construction industry, and to small and mid-sized businesses, including veteran-owned and controlled firms.

The Surety & Fidelity Association of America (SFAA) is a trade association of more than 450 insurance companies that are licensed to write surety and fidelity bonds. SFAA members collectively provide the vast majority of performance and payment bonds on federal and state construction projects in the United States.

We are here to provide our assessment of the ability of small contractors to do business with the Department of Defense (DOD). In particular, we can provide information on underwriting performance and payment bonds and how to enhance the bonding of small and emerging contractors and increase their participation in DOD construction projects.

One of the many requirements for performing construction projects for the DOD as well as other federal agencies is to provide surety bonds to protect the taxpayers and the workers on the construction project. For small and mid-sized contractors this requirement provides both protections and challenges.

The Role of Surety Bonds in Federal Construction Projects

There is good public policy for the universal requirement of surety bonds on public construction projects. These performance and payment bonds guarantee that the project will be completed and that the subcontractors, suppliers, and laborers on the job will be paid. If the surety bonds a contractor that defaults on a project, the full amount of the surety bonds is available to complete the work and pay those who worked on the job. Congress, all states, and many municipalities recognize the value of these bonds and have bond requirements in place.

A performance bond secures the contractor's obligation to perform the construction contract. A payment bond secures the contractor's obligation to pay its laborers, subcontractors, and suppliers. In determining whether to provide the required bonds to a contractor, a surety company makes an assessment of the contractor's ability to perform the construction contract. The surety's assessment must take into account the size and scope of the underlying obligation, the construction 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 surety's evaluation of a contractor is designed to avoid defaults on public construction projects. When a surety is willing to issue bonds to a contractor, the surety is giving the public contracting entity the benefit of an independent third party opinion that the contractor is capable of performing under the construction contract. The surety's own assets are at stake if the contractor fails. The public contracting entity can safely accept the lowest bidder because the contractor is bondable.

If the contractor defaults and additional funds are needed for completion, the surety pays the excess cost to complete, up to the dollar amount of the bond. The performance bond ensures that the project is completed for the contract price. The payment bond assures that subcontractors, suppliers, and workers on the job will be paid. 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. Because small and emerging contractors most likely start on federal projects as subcontractors, they need the payment bond to be in place. Without a payment bond, such persons have no other remedy if they are not paid. For a small and emerging contractor, not being paid on the last job can be devastating.

What Will Work to Assist Small and Emerging Contractors to Contract with the DOD?

Award Reasonably Sized Contracts

There is a direct connection between a contractor's capability and its bondability. If a contractor is bidding for a job too large for its business to perform, it will have difficulty in obtaining the required surety bonds. Over recent years the size and dollar value of contracts being let by DOD has increased, yet the ability of small and mid-sized contractors to perform, almost by definition, cannot match that increase. Therefore, many of the contracts from the DOD and other agencies simply are too large for small contractors to perform. Such contractors can and should work on such large projects as subcontractors.

Unbundle Contracts

However, not only are individual contracts too large, frequently contracts that do not need to be bundled together are bundled into one contract and one bid. While this may assist in administration of the contract for the DOD, it directly impacts the ability of small and mid-sized contractors to perform the contract and, consequently, the ability to obtain the necessary surety bonds.

To address the needs of small businesses, federal procurement rules should contain both mandates and incentives to break construction contracts into smaller parts to create genuine opportunities for small businesses. A federal court recently held that federal construction projects were not explicitly subject to the anti-bundling provisions in the federal regulations, and, therefore, contract bundling cannot be challenged in the construction arena. Federal construction contracts need to be subject to the current anti-bundling regulations.

SFAA also recommends that any federal agency letting construction contracts should let 5% of its total construction budget in contracts of no more than $5 million. These contracts would be part of the agency's federal small business participation goals. Any contract under $5 million in excess of this 5% requirement should be credited as $5 million towards the agency's small business participation goal, regardless of the actual dollar amount of the contract.

Address Set-Aside Goals and Projects

All federal agencies have a goal that requires 23% of the total dollars awarded in government contracts to go to small businesses. This ambitious goal combined with a stretched procurement work force within the federal government leads to project opportunities that are set aside for small and emerging contractors but are too large for them to perform. Contracting agencies argue that they do not have a sufficient number of contracting officers to manage a higher number of low-dollar projects. The high dollar value of some federal government construction projects, however, makes these projects impossible for a small contractor to undertake. SFAA staff is aware of instances of DOD small business construction project opportunities valued in excess of $50 million. In the construction business, small really means small. Qualified small contractors that are "small" in accordance with the applicable regulations (up to $33.5 million in annual revenues under the SBA standard for general contractors) can get bonding at some level, and could perform some of the work, but cannot take on a $50 million project. There often is a disconnect at the federal level between the size of projects that are advertised to meet small business goals and the size of construction projects that small construction contractors are qualified to perform. To address the disconnect, the federal government should set its procurement policy to give small contractors access to projects they are capable of performing.

Allow the Joint Venture and Mentor-Protégé Programs To Work More Effectively
Mentor-protégé programs and joint ventures with larger contractors provide a means for small contractors to participate in public construction projects too large for them to perform alone. The current federal regulations, however, lack clarity and standardization among the procuring agencies as to what arrangements are acceptable. In addition, the regulations present a disincentive for smaller contractors to participate in federal construction projects with larger contractors in joint ventures or mentor-protégé programs. For example, a small business may lose its status as "small" if it participates in a joint venture in which the joint venture partner does not qualify as a small business or, in some cases, such as the 8(a) mentor-protégé joint venture, the protégé does not control the joint venture. Once an otherwise qualified small business loses its status for that particular set-aside opportunity, the small contractor cannot take advantage of the set-aside opportunity and the federal agency letting the construction contract faces an obstacle in meeting its small business participation goal. Yet, just because a contractor is too small to complete all of the work on that project, does not mean that it cannot do a significant part.

SFAA suggests that small businesses should not lose their status and be disqualified from bidding on a small business opportunity because of their participation in mentor-protégé programs or joint ventures or because bonds were issued based on the strength of the other joint venture partner. SFAA recommends that federal regulations explicitly permit open joint ventures between a small contractor and a larger contractor. The larger contractor's indemnity to the surety for losses under the bond should not threaten the small contractor's status. These new rules could apply to construction contracts under a certain dollar value, such as $50 million, to assure that only small businesses benefit from them. An additional requirement could be that on any project in which the small contractor is in a joint venture with a larger contractor, the small contractor must self-perform at least 10% of the work on jobs between $25 million and $50 million and 15%

of the work on jobs under $25 million. Finally, Congress should consider allowing federal agencies letting construction contracts on this basis to count some multiple of the small contractor's self-performed work (such as two to three times the amount of work self-performed by the small contractor) towards their small business participation goals.

Improve Small Business Programs
The Surety Bond Guarantee Program (Program) of the Small Business Administration (SBA) was created to assist small and emerging contractors in obtaining bonds. Over the years, however, the Program has become increasingly less effective. Significant reform is necessary to enhance the opportunities for small businesses, and the Program needs to be changed to maximize the number of bonds made available to small businesses. Many of the changes needed would be similar to those that have been made to the SBA loan programs. The Program should increase the SBA guarantee to sureties so that they are up to 95% of the bond amount. Congress also should increase the size of contracts that can be guaranteed to $5 million and up to $10 million if a federal agency's contracting officer certifies that the guarantee is necessary. The existing Prior Approval Program and the Preferred Program should be combined into one bond guarantee program, creating a unified model based on the Preferred Program concept and implemented in a manner consistent with this concept. These are changes that SFAA continues to work on with the House Small Business Committee.

Improve Access to Capital
Many times, what is perceived to be a bonding problem is not. Small and emerging contractors that are having difficulty in obtaining bonding actually may have a capital problem. In the current credit crunch, they may not be receiving the bank lines of credit that they need to provide the financial stability to their business. Small contractors need capital, capacity, and experience in order to obtain bonds. A capital access program combined with a surety bond access program would be the best solution for some contractors.

Consider a Surety Bond Program
Just as the surety's underwriting is based on the contractor's ability to manage contracts successfully, the focus of any effort to assist small and emerging contractors to obtain the necessary bonding should be on enhancing the contractor's financial and operational capabilities. This is the proven recipe for success in enhancing job opportunities for small and emerging contractors.

For over a decade, SFAA has assisted small and emerging contractors to become bondable through its Model Contractor Development Program (MCDP)®. In the past three years alone, more than $150 million in bonding has been offered or issued by Treasury-listed surety companies, all of whom also are licensed by the insurance departments in the states in which they do business, through the MCDP.

The current MCDP is comprised of two distinct components: education and bond readiness. The educational component offers eight comprehensive workshops on topics that include construction accounting, bonding and insurance, and estimating and bidding.

These workshops are designed to assist contractors in improving their operations and make it easier for them to obtain bonds. Most of the classes are taught by local volunteers from the surety companies and bond producers. The surety industry has a great incentive to participate in these programs as every company and agent always wants to write more bonds. They look for ways to develop relationships with small and emerging contractors who will grow and move on to bigger projects.

After the workshops are completed, the bond readiness component provides one-on-one interactions with surety bond producers, underwriters, and other professionals who work with the contractors 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. The Construction Financial Management Association (CFMA), Associated Builders and Contractors (ABC), Associated General Contractors (AGC), and National Association of Surety Bond Producers (NASBP) provide local instructors and assistance in the bond readiness component. The MCDP has been implemented on a national, statewide, and local basis to address bonding issues.

Through the MCDP, SFAA has partnered with more than a dozen states, counties, and municipalities, as well as agencies of the federal government. Most recently, SFAA and the U.S. Department of Transportation (DOT) jointly launched a national program of bonding education and assistance for small and emerging contractors. This is the first national implementation of our MCDP to date. SFAA entered into a Memorandum of Agreement to assist DOT to design, develop, and implement a pilot component of the DOT Bonding Education Program (BEP). Initial workshops were conducted in three pilot cities—Chicago, Dallas, and Atlanta. More than 50 contractors completed the workshop phase of the program, several have been bonded, and the remaining contractors are engaged in various stages of bond readiness activities.

After the successful pilot phase, in 2011 DOT/SFAA embarked on a national rollout of the program in ten additional cities around the country. Already, workshops have been completed in Baltimore, Raleigh, Miami, Orlando, Los Angeles, New Orleans, Denver, Seattle, Minneapolis, and New York City, in that order. Bond readiness activities, in which volunteer bond producers work one-on-one with the contractors, are now underway in all these cities, and some bonding already has been approved or still is pending as a result of these programs.

Planning now is underway for the 2012 round of initiatives, and cities identified thus far include Chicago (a second round), Columbia, SC, Norfolk, VA, Philadelphia, San Francisco/Oakland, Little Rock, Oklahoma City, Portland, OR, Salt Lake City, Milwaukee, and Nashville/Memphis. Three cities currently are scheduled for 2012: Montgomery, AL, Louisville, KY, and Albany, NY. A system has been developed that is tracking the status of the program at each location, including the number and amount of bonding offered or put in place.

In implementing the BEP, SFAA is utilizing the DOT network of Small Business Transportation Resource Centers (SBTRCs). The DOT's Office of Small and

Disadvantaged Business Utilization (OSDBU) enters into Cooperative Agreements with business-centered community-based organizations, transportation-related trade associations, colleges and universities, community colleges, and chambers of commerce to establish SBTRCs on a region-wide basis. Industry underwriters and broker/agents throughout the country are voluntarily participating in the educational workshops and bond readiness activities of this program.

The MCDP works well because it is more than just a series of workshops. The MCDP demonstrates the surety industry's commitment to making bonding available to all sectors of the construction community. The MCDP introduces these small and emerging contractors to professional bond producers and regulated surety companies who are committed to providing surety bonds to small contractors. The MCDP provides both information and access to other resources that small and emerging contractors need to better manage their companies and improve their bondability. Furthermore, the MCDP results in successful bonding outcomes and relationships that allow the contractors to manage growth and increase their chances for long-term viability.

If there are problems with contractors not being able to obtain bonds for DOD construction projects, SFAA would be happy to assist the DOD with such a program specifically designed for small and emerging DOD contractors.

Protect the Federal Bond Threshold

Payment bonds protect small and mid-sized contractors and their workers. 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 laborers, 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 Miller Act 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. This was done after persuasive testimony from small contractors and subcontractors that this payment protection was critical to the survival of their businesses. Congress decided not to increase the threshold below which bonds were not required, and the final regulations provided that a payment bond is one of the preferred types of payment security for contracts between $25,000 and $100,000.

In 2008, a provision was added to the National Defense Reauthorization Act that requires inflation adjustment of all acquisition-related thresholds every five years. Certain thresholds, meant for public protection, however, specifically were excluded from this provision.

The threshold for bonding construction contracts under the Miller Act should be added as an exclusion, since increasing this threshold exposes more small construction businesses to loss of payment protection on federal construction projects. The Miller Act is a statute enacted for protection for laborers, subcontractors, suppliers, and U.S. taxpayers.

The Federal Acquisition Regulatory Council already has relied on the revised law to increase the threshold for payment security under the Miller Act. In 2006, the contract size threshold for payment security on federal construction projects was increased from $25,000 to $30,000 under the Federal Acquisition Regulation. In 2010, the Council increased the threshold for performance and payment bonds from $100,000 to $150,000, significantly increasing the number of contracts in which protection to small businesses and taxpayers is not provided. This again was done by regulation. This dramatic increase is a bad idea but one mandated by the law. In addition, H.R. 1540, enacted this year, increases the specific statutory threshold for military construction and military housing from $100,000 to $150,000.

As stated above, many laborers, subcontractors, and suppliers often find that their best entry into the federal procurement arena is as a subcontractor. Surety bonds, in the form of payment bonds, ensure that they are properly paid. Such protection cannot be compromised as a result of periodic adjustments for inflation. Each increase, which may occur every five years, means that more federal subcontractors and suppliers work on projects without the protection of a payment bond. Periodic adjustments to address inflation should not decrease the protection that performance bonds provide to the U.S. taxpayers. These bonds protect the taxpayer from loss if the contractor on a federal project defaults.

Summary and Conclusion

The challenge for Congress in addressing the needs of small and mid-sized companies is to strike the right balance among operational efficiency, opportunity, and fairness. There are programs available to the DOD that can be effective in enhancing bonding access and contracting opportunities. In addition, SFAA's procurement recommendations provide methods to significantly increase small business participation in federal construction work and help all procurement agencies meet their goals.

SFAA would be happy to work with the DOD on this important issue.