

Bid, Payment, and Performance Bond Update for Virginia Public Projects

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Effective July 1, 2011, the threshold at which contractors must furnish bid bonds, performance bonds, and payment bonds to Virginia public bodies for construction projects, will increase under certain circumstances. House Bill 1951ER2 amends the Virginia Public Procurement Act, specifically Va. Code § 2.2-4336 and § 2.2-4337, to raise the threshold when bonds are required for non-transportation-related construction contracts. Prior to July 1, 2011, the threshold for when bonds were required for non-transportation-related construction contracts was for "contracts in excess of \$100,000." Effective July 1, 2011, the new threshold for such contracts, provided that the public body has prequalified prospective contractors in accordance with Va. Code § 2.2-4317, is for "contracts in excess of \$500,000." If the public body does not do prequalification, the threshold to require bonds for such contracts remains \$100,000. The threshold for certain transportation-related projects remains \$250,000.

As noted, public bodies not requiring bonds for non-transportation-related construction contracts in excess of \$100,000 but less than \$500,000¹ must prequalify the prospective contractors for the individual project at issue in accordance with Va. Code § 2.2-4317. If the public body does not do such prequalification, it must require bonds for such contracts. Also, public bodies may still require bonds for projects below the new threshold if they wish, regardless of whether they prequalify prospective contractors.

Eliminating a bond requirement can result in some cost savings to the contractor. These cost savings to the contractor are typically considered a pass-through to the owner and would presumably be passed on to the public body owner that elects not to require bonds. The premium paid by a good contractor² to a surety for bonds might run in the range of 1 percent of the contract amount. A stronger contractor might have a lower premium - say .7 percent or .8 percent. A weaker contractor may have a higher premium. A very weak contractor may have a premium of several percent of the contract amount. Eliminating a bond requirement on a \$500,000 contract might save \$5,000 on general contractor bond premiums with a good contractor.

Nonetheless, by waiving the requirement for bonds, the public body assumes certain risks. These include: (1) that the low bidder might refuse to honor its low bid; and (2) that the contractor who is

awarded the contract may fail to perform, and no adequate financial backstop will exist to ensure performance without additional cost to the public body. The use of a prequalification procedure as required by the amendments may help reduce such risks. However, even a well-qualified contractor may encounter difficulties that cannot be discovered at prequalification and that ultimately make it unable to perform. Use of a schedule of values and retainage to avoid payment to the contractor beyond the value of the work provided may be insufficient to mitigate this risk. A bond from a surety of reasonable financial strength and size helps protect against this risk. Also, a bond, with the attendant potential liability by the contractor's principals and their spouses to indemnify the surety³, may provide greater motivation for the contractor to avoid a default.

Drafting the solicitation and alternative methods of procurement allowed by the Virginia Public Procurement Act may provide ways to mitigate some of the risk posed by waiving the requirements for bonds. For example, if the public body makes the determination required by Va. Code § 2.2-4303.D and then elects to proceed by competitive negotiation, the public body might be able to negotiate some substitute for a performance bond from the general contractor that does not involve a surety and the attendant premium costs, such as a guaranty. Also, it may be possible to draft the solicitation to provide protections similar to those offered by a bid bond, albeit with the public body's recourse being against the bidder, without the financial backing of a surety.

Ultimately, whether a public body should require bonds on non-transportation construction contracts below the \$500,000 threshold is a judgment call where the public body must weigh potential cost savings against the greater risk involved. The recent amendments allow public bodies to make that judgment call. Use of prequalification procedures, as the recent amendments mandate if bonds are not required, may help mitigate the resulting greater risk somewhat but not completely. Other existing provisions of the Virginia Public Procurement Act and drafting of solicitations may provide some additional means to mitigate that risk.

1. The language of the new amendments does not precisely mesh. Va. Code § 2.2-4336.B and § 2.2-4337.B speak of contracts of "less than \$500,000" requiring prequalification where bid bond requirements are waived, while language added to § 2.2-4336.A and § 2.2-4337.A requires bonds for certain contracts "exceeding \$500,000." Read literally, the language would allow a public body to dispense with bonds

without prequalification if the contract amount was exactly \$500,000. This makes no sense. Similarly, amendments require prequalification when the "bid bond" requirements are waived, not mentioning performance or payment bonds. *Id.* Again, this makes no sense. Despite these anomalies in statutory language, a public body would be well-advised to use prequalification even if the contract amount is exactly \$500,000 before waiving bond requirements, and to treat its waiver of bid, performance, or surety bond as triggering the prequalification requirement.

2. The premiums sureties charge contractors for bonds vary with how sureties assess the risk that the contractor who will be its principal on the bond will not complete performance or will not pay subcontractors. Sureties have varying underwriting criteria, and they may look at a number of factors to assess such risk, including the contractor's financial strength, its past performance, the nature of the project, and whether the project is within an established area of the contractor's past performance and competence. Also, sureties typically require the principals of a contractor they are bonding and their spouses to agree to indemnify the surety for any costs incurred by the surety with respect to an owner taking action under the bond.

3. See note 2, *supra*.

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