LEG. FINANCE - BILLS 1983 - 1984 1955

HB 610 cont. 1955

What is required to obtain a contractor's license?

Among those states that require contractors to be licensed, Alaska's standards are relatively nonrestrictive. Alaska does not require demonstration of knowledge or experience in order to obtain a license to contract for general building construction or repairs. Alaska requires only that an applicant complete an application, pay the registration fees, obtain a $5,000 surety bond ($2,000 for specialty contractors) or file an equivalent cash deposit, obtain a business license and provide evidence of insurance covering public liability, property damage and workers' compensation. Several states require that an applicant pass an examination and provide evidence of four or more years of experience in the construction field. Some states have more stringent requirements related to an applicant's financial situation, character, integrity, qualifications and age.

What are the consequences of failure to comply with the law?

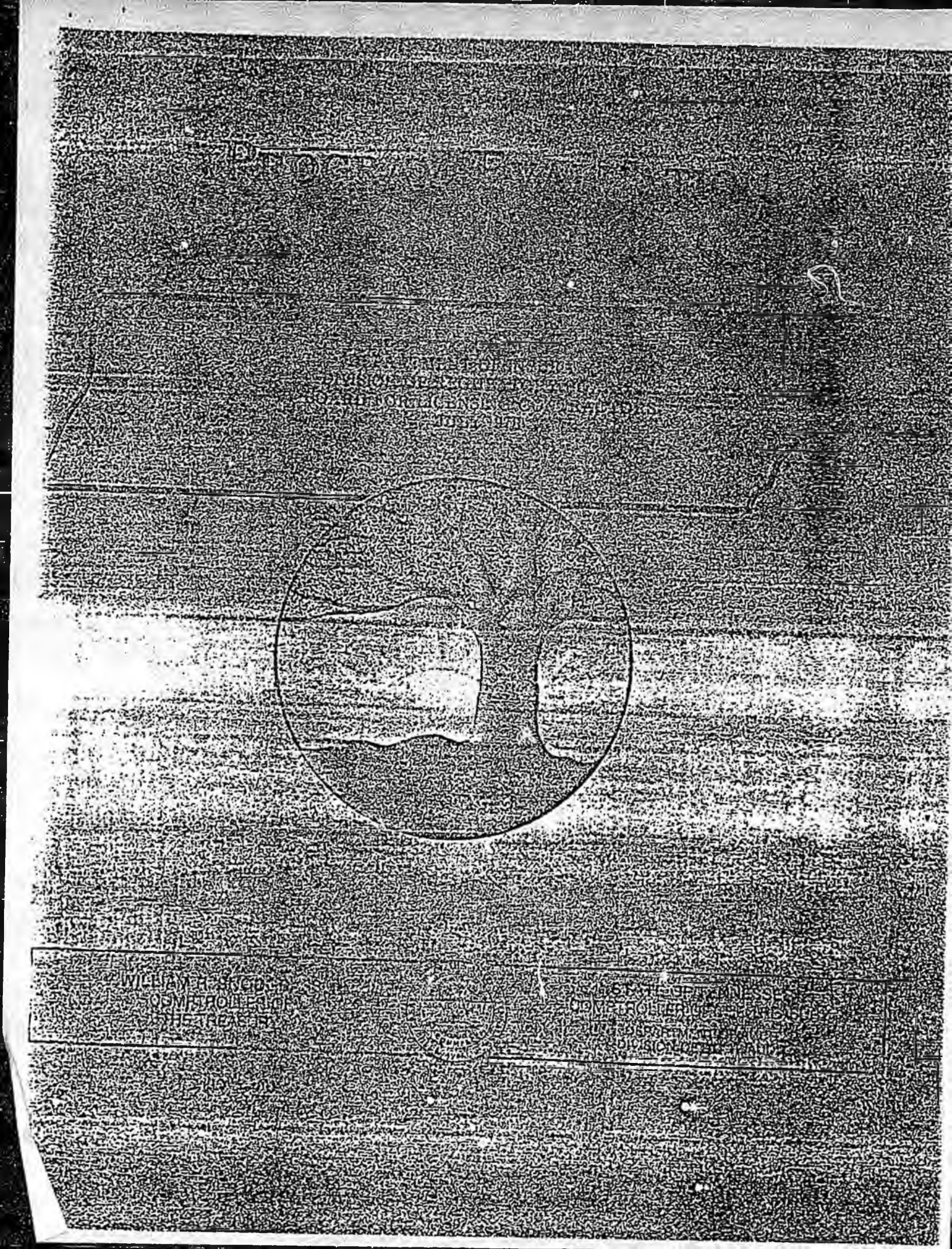
AS 08.18.141 states that "a person acting in the capacity of a contractor in violation of this chapter is guilty of a misdemeanor." This penalty appears to be common among states that require contractors to be licensed. The method of recovering damages from bonded contractors in Alaska also appears to be normal procedure in other states. The surety bond issuer is not liable for claims in excess of the amount of the bond, and claims for breach of contract are assigned a lower priority than claims for labor costs and taxes which may be owed to government units.

* * *

The Associated General Contractors of America has written a letter on this subject to each state. When results from that survey are available, they will be forwarded to your office. Previous work by the House Research Agency on the subject of contract bonding is attached to this memorandum. I hope you find the information useful.

DT

Attachments
Research Request 80-147
Exhibit I, State of Tennessee Program Evaluation



LIMITED PROGRAM EVALUATION
BOARD FOR LICENSING CONTRACTORS
JULY 1978

INTRODUCTION

PURPOSE AND AUTHORITY FOR THE EVALUATION

This limited program evaluation of the Board for Licensing Contractors was conducted in accordance with the Tennessee Governmental Entity Review Law, Tennessee Code Annotated, Title 4, Section 29. The evaluation is intended to aid the legislative evaluation committee in determining whether the Board for Licensing Contractors should be abolished, continued, or restructured.

OBJECTIVES OF THE EVALUATION

The primary objective of the limited program evaluation was to address the criteria for review outlined in TCA 4-2911 and 4-2912. The secondary objective was to determine the issues involved in licensing contractors. An attempt was made to gather all pertinent information relating to these issues, and any other information which would aid the legislative evaluation committee.

SCOPE AND METHODOLOGY

The scope of the evaluation was the activities of the Board for Licensing Contractors for the last three years—1975, 1976, and 1977. This report is based on the following:

- Examination of minutes, correspondence, and other records of the board;
- Questionnaires completed by the board and its executive director;
- Intereviews with board members, staff, and other state and local officials;
- Interviews with licensing and consumer officials of the southeastern states;
- Correspondence with other states and national organizations;

- Examination of resource materials and publications concerning contract construction; and

- Observation of board meetings.

OF THE
BOARD FOR LICENSING CONTRACTORS

HISTORY AND BACKGROUND

The first legislation regulating the construction industry in Tennessee was passed in 1931. Under the first law only general contractors were licensed. The original law defined a general contractor as any person who completed or improved a structure where the cost exceeded $10,000.

The original law was repealed in 1945. The 1945 law included provisions for the licensure of subcontractors who contracted work in excess of $10,000. In addition this statute fixed standards of qualification and eligibility, provided for revocation of licenses for cause, and provided penalties for other violations.

In 1965 an amendment was passed that exempted residential contractors in counties with populations less than 60,000. According to the 1970 census only ten counties in Tennessee have populations over 60,000. As a result of this amendment, 46 percent of the population in Tennessee is not affected by the residential licensing requirement. If there is a public purpose involved in licensing homebuilders in urban areas, there should also be a public purpose in licensing rural homebuilders. The feeling of the current board is that the law should apply equally to both rural and urban homebuilders.

In 1972 the contractors act was amended again. The major alteration was to clarify that only subcontractors engaged in performing plumbing, electrical, heating, ventilating, or air conditioning work were required to be licensed. The 1972 amendments also raised the minimum contract amount which necessitated the licensing of contractors and subcontractors from $10,000 to $20,000.

In 1976 a new contractors licensing act was passed. The act included the update and revision of obsolete and ambiguous sections of the previous law. It also provided for certain exemptions and bidding provisions (see Summary of the Current Law, page 8). In 1977 the minimum contract amount requiring a contractor and subcontractor license was increased from $20,000 to $50,000.

SUMMARY OF THE CURRENT LAW

1. The Tennessee Board for Licensing Contractors is created by TCA 62-604, and is charged with the administration of that act.

2. This act applies to: any person, firm, or corporation engaged in contracting in this state where the cost of the completed structure or improvement, or of different structures and improvements under the same contract, exceeds $50,000. The act applies to subcontractors who engage in electrical, plumbing, heating or ventilating and air conditioning classifications or contracting where the amount of the subcontract is equal to or greater than $50,000.

3. This act does not apply to: any person, firm, or corporation in a county with under 60,000 population according to the 1970 census, who engages in his county of residence in the construction of residential buildings; any person, firm, or church that owns property and constructs thereon single residences, farm buildings or other buildings for individual use, not for resale, lease, rent or similar purpose.

4. An applicant for a first-time license is charged a fee of $75, and a renewal fee of $35 is charged each year after that.

5. Each approved applicant is issued a license to construct in certain classifications, i.e., industrial, commercial, residential, and a single contract limit above which he may not bid, e.g., $100,000, $1,000,000, $2,000,000.

6. Every contract awarded for more than $50,000 requires that each bidder represent his license number, classification, and expiration date on the outside of his bid. Penalties are provided for violation of this provision.

The board is authorized to:

1. Administer the contractors licensing act, rules and regulations;

2. Make bylaws, rules, and regulations;

3. Determine the qualifications of candidates (experience, education, finances, and equipment);

4. Conduct written or oral examinations;

5. Determine classifications and bid levels;

6. Revoke or suspend (after a hearing) any license or renewal granted;

7. Initiate inquiries and investigations;

8. Prosecute violators subject to the approval of the Commissioner of Insurance.

STATE COMPARISONS

As shown in Exhibit 1 on page 10, there are 28 states that in some manner license or register contractors or subcontractors. Twenty of these states license contractors in a manner similar to Tennessee. Four states license only some specialty contractors—for example, electrical contractors—two states license only nonresident contractors, and Delaware licenses contractors for revenue purposes only. Of the eight states bordering Tennessee, all license contractors except Kentucky and Georgia.

Eleven states which license contractors in some manner require surety or performance bonds from non-resident, general, or public works contractors. Different bond payments are required in order to assure that nonresident contractors pay taxes, and that general or public works contractors complete their awarded projects. The Tennessee contractors act does not require any surety or performance bonds.

There is great variability in the state laws regulating contractors. Before issuing a license most states require the assessment of an applicant's financial statement, bank and material supplier references, construction experience and equipment. Several states require contractors to report any personal or corporate bankruptcies to the board; however, the Tennessee law does not include such a provision.

ORGANIZATION AND STAFFING

The Board for Licensing Contractors consists of seven licensed contractors appointed by the governor for seven-year terms. The board is composed of one subcontractor, one homebuilder, and five other licensed contractors who have had at least ten years of construction experience.

The administrative staff to the board consists of one executive director, one executive aide, three clerk II's, one typist, and one investigator (see Exhibit 2, page 11 for organization chart). The major functions of the administrative staff pertain

EXHIBIT 1

States Licensing General Contractors

States	License Contractors	License Subcontractor	Dollar Limit	Bond Requirements
1. Alabama	Yes	No	$20,000	No
2. Alaska	Yes	No	1,000	$2,000 Surety
3. Arizona	Yes	No	NA	1,000 to 15,000
4. Arkansas	Yes	Yes	20,000	No
5. California	Yes	Yes	100	2,500
6. Florida	Yes	No	NA	No
7. Hawaii	Yes	No	NA	No
8. Louisiana	Yes	No	30,000	bond(1)
9. Maryland	Yes	No	5,000	amount-NA
10. Michigan	Yes	No	200	No
11. Mississippi	Yes	Yes	10,000	No
12. Montana	Yes	No	15,000	No
13. Nevada	Yes	Yes	NA	amount-NA
14. New Mexico	Yes	No	NA	No
15. North Carolina	Yes	No	30,000	No
16. North Dakota	Yes	Yes	500	No
17. South Carolina	Yes	No	30,000	No
18. Tennessee	Yes	Yes(2)	50,000	No
19. Utah	Yes	Yes	NA	bond(3)
20. Virginia	Yes	Yes	30,000	No
21. Washington	Yes	No	250	1,000 to 2,000

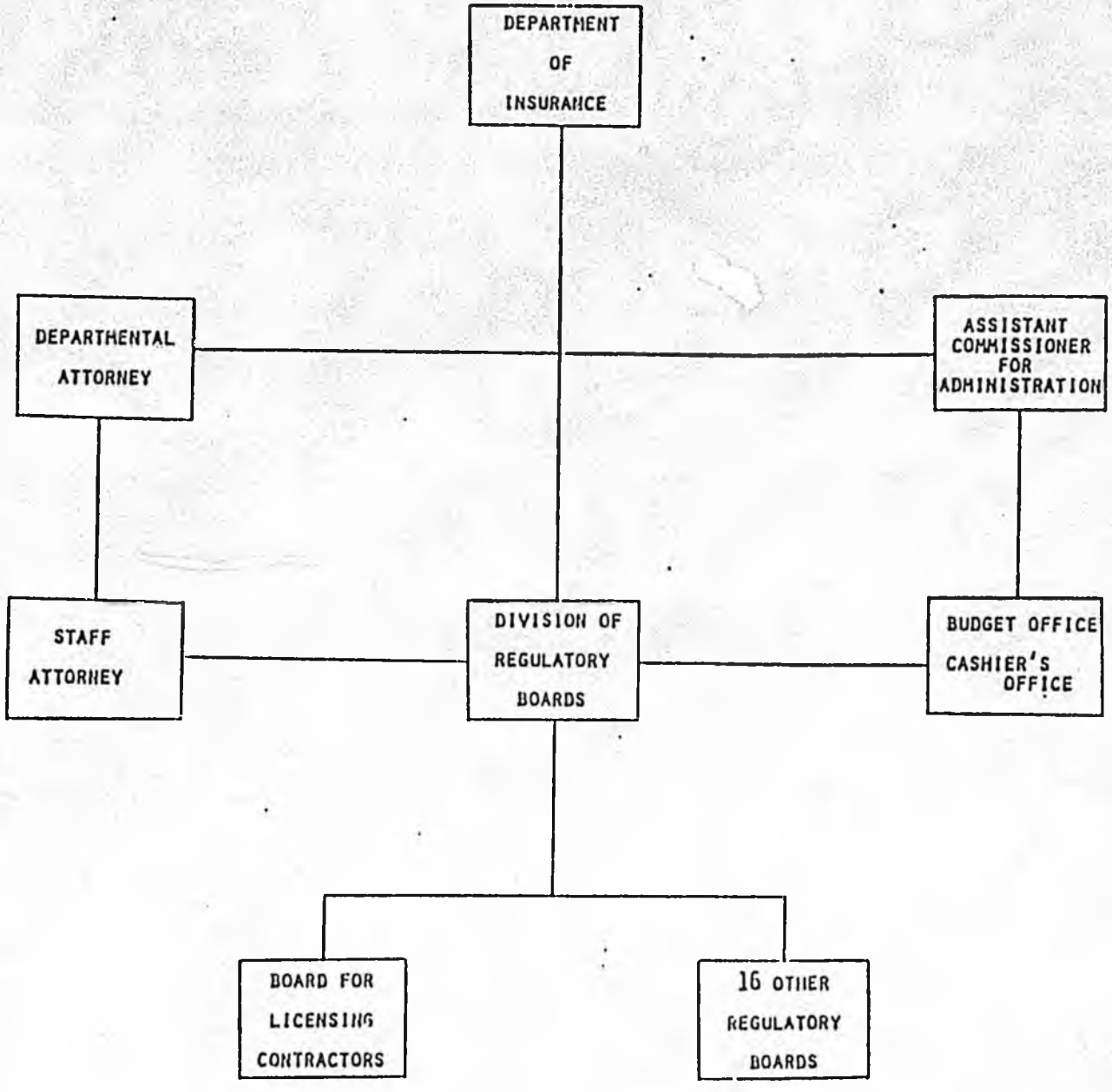
States Licensing Specialty Contractors

States	Type of License	Bonding Requirements
22. Idaho	Public Works Contractors	No
23. New Jersey	Electrical Contractors	No
24. Oregon	Residential Building Contractors	($3,000 bond require
25. Wyoming	Electrical Contractors	No
26. Delaware	Registers Contractors for revenue only	No
27. Kansas	Nonresident Contractors	$1,000 bond requirem
28. Nebraska	Nonresident Contractors	$1,000 bond requirem

(1) Surety Bonds required for taxes on nonresident contractors.
(2) License only subcontractors who perform heating and ventilating, air conditioning, electrical, and plumbing work where the contract cost exceeds $50,000.
(3) 50 percent performance bond for public works contract.

amount NA-dollar amount not available.

EXHIBIT 2. ORGANIZATION CHART: BOARD FOR LICENSING CONTRACTORS



to licensing and renewal activities. The staff is responsible for compiling the roster, renewing licenses, issuing original licenses, preparing for board meetings, and all related notification and clerical work.

The board has proposed in its fiscal year 1978-79 budget to computerize the licensing process at a cost of $2,894. The computer could send out renewal notices and type renewal licenses, post renewal payments, notify delinquent contractors, keep track of expired licenses, type the annual roster, type and address all mailing labels and keep a record of all licensing information such as bid limits and classifications. These are essentially the same functions a Clerk II now performs. Generally, a computerized system requires careful planning for successful implementation. A computerized system is usually added when it results in savings in time and personnel costs.

Recently many states have included public members on regulatory boards. This trend has resulted from criticism that licensing boards are composed exclusively of representatives of the regulated industry or profession. The Tennessee Board for Licensing Contractors does not have a public member.

The board is required by law to meet six times per year (in January, March, May, July, September, and November) for interviewing applicants and evaluating applications and extensions of bid limits. Each session lasts two to three days and board members are compensated for travel and boarding expenses but receive no per diem. Members of all other regulatory boards in the Department of Insurance receive compensation (salary or per diem) and travel and boarding expense. In all other southeastern states that license contractors, board members receive per diem payments.

LICENSING ACTIVITIES

1. Licensing Procedures

According to the contractors' rules and regulations 0680-1-.01, an applicant desiring to be licensed must have reference inquiries from: (1) an architect or engineer; (2) a bank; (3) a material or supplies dealer; and, (4) another contractor. The candidate must also complete a personal questionnaire covering his business finances, equipment and experience. For bid limits under $500,000 the financial statement in the questionnaire may be prepared by the applicant and notarized; if not prepared by the applicant it must be signed by a certified public accountant (CPA), a public accountant (PA), or a bank officer. For bid limits over $500,000 the financial statement must be prepared by a CPA, PA, or bank officer. The financial statement required of the applicant is a balance sheet, which is not required to be audited, and which may or may not reflect an accurate picture of his financial situation. The board has the authority to require an audited financial statement before a license is issued; however, they have not utilized this authority.

After all reference and questionnaire forms have been properly completed the applicant is scheduled for a hearing with the board. During the hearing, or interview, the board divides into groups to question the applicant in order to insure that he has proper experience, finances, and equipment. If the applicant's finances are on the "light side" as determined by the board, the board will require the applicant and/or partners to indemnify the company. Indemnification is a procedure which requires that applicants send in current personal financial statements and agree to stand personally liable for their company's actions. Subsequent to the interview the board determines the classification and bid limit that is warranted by the applicant's finances,

experience, and equipment. For example, an applicant might be granted a license to engage in the classifications of residential and commercial building with a per contract bid limit of $200,000. This does not restrict the licensee from taking on any number of jobs at this bid limit. For example, a contractor with a $100,000 bid limit could have ten or fifty jobs for $100,000 each underway at any one time. Therefore, the bid limit in itself is not an effective method of insuring financial responsibility.

In the first year of the board's operations, 177 general contractors were licensed. As of 1977 over 6,511 contractors and subcontractors were licensed by the board. According to the board, from 1974 to June 1977, 33 applicants, or 1.45 percent of those who applied, were denied licenses.

Reasons for Application Denials

A.	Insufficient Working Capital	21
B.	Lack of Experience	3
C.	Bad Recommendations	5
D.	Lack of Required Information Submitted	3
E.	Information Submitted Falsified	1

2. Classification

There are approximately 200 different classifications of construction work in Tennessee. There is no easy way to get an accurate total number of classifications, due to the lack of a standardized or uniform classification system. The effect of this is that it is not clear what types of construction activities the board is authorizing when it issues a license. This is especially true in specialized fields of contracting such as utility construction. The board has realized these difficulties and has been working on a new classification system which should be adopted sometime in the spring of 1978.

The idea behind classifying contractors is to make sure that contractors engage in only the categories of work for which they are qualified by experience and expertise. Although currently no guidelines exist for determining whether or not a contractor is qualified in a certain classification and there are difficulties in the standardization of categories, classifying contractors is still one of the most effective means available to the board to assure quality construction. It is especially important in the more technical areas of construction which demand more expertise—for example, high rise buildings or sewage treatment plants.

3. Criteria for Licensing

As previously mentioned, the factors the board considers when issuing a license are the applicant's experience, equipment, references, and financial situation. The principal determinant appears to be the applicant's financial situation and the second most important is evidently experience. The applicant's references are not verified, and it appears to be sufficient to have access to the right type of equipment to be licensed.

Neither the contractors law nor the rules and regulations states any criteria to guide the board in its decisions. The rules and regulations 0680-0-.01 state "Sufficient finances, equipment, and experience must be shown to enable the contractor to do the work applied for, in the discretion of the Board" (emphasis added). How the board arrives at the classifications and bid limits that are granted is unclear. For example, there are no established criteria regarding the experience requirements or the examination.

Five of the eight southeastern states that license contractors require applicants to pass written examinations before licensure. The written examinations cover the applicant's general knowledge in the classification of work

applied for, general knowledge of construction methods, safety, health and lien laws of each states. The southeastern states that require examinations are shown below:

Southeastern States	Examinations
1. Virginia	written*
2. Florida	written
3. Louisiana	written
4. North Carolina	written
5. South Carolina	written
6. Tennessee	oral or written
7. Alabama	oral or written
8. Mississippi	oral or written

*written exam required for plumbers and electricians

Currently, the Tennessee Board for Licensing Contractors gives an interview or oral exam. The board prefers an interview over a written test for the following reasons:

1. Knowledge of the contractor concerning experience, equipment, and specialties is examined through the interview.

2. Some contractors cannot pass a written exam but can perform quality construction work.

3. Compiling a fair test on methods, specialties, etc., would be difficult.

4. An exam on safety and lien laws would be unfair because they are constantly changing.

5. Some construction companies or corporations are highly specialized and rely on several partners' expertise to run their companies. Therefore, it would be difficult to test only one partner, and unfair to test all.

The arguments for a supplemental written exam are:

1. More objectivity is instilled in the board's decision-making.

2. Greater uniformity in the granting of licenses is assured.

3. Increased assurance is obtained that contractors are familiar with state health, safety, and lien laws.

Tennessee does not have any stated criteria for determining bid levels. The board has followed an unofficial policy of issuing a bid limit of 10 times the candidate's quick assets.[1] However, the board frequently deviates from this policy. In a random sample of 110 renewal financial statements, original licenses, and extensions, 31.8 percent of the bid levels were over 10 times the applicant's quick assets, and 17.2 percent had negative net working capital.

Other states have established minimum criteria that candidates must meet to be licensed at a certain bid level. For example, in North Carolina:

> Total current assets of at least $7,500 in excess of total current liabilities are required for a Limited License. Total current assets of at least $35,000 in excess of current liabilities are required for an Intermediate License. Total current assets of at least $65,000 in excess of total current liabilities are required for an Unlimited License.[2]

Written minimum criteria give notice to the applicant of what is required for a bid limit, allow for greater uniformity between bid levels, and help to assure continuity of action when the composition of the board changes. For example, a minimum standard for a bid limit of $50,000 might be one year of experience in the type of construction classification sought, and a net working capital of $5,000.

Several members of the board expressed the view that applicants' experience and expertise are adequately checked through the interview. However, observation of the interviews revealed them to be quite brief—five to ten minutes long—and emphasizing the financial status of the applicant.

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[1] Quick assets, or net quick, is (current assets-inventory) - current liabilities.

[2] Correspondence with C. S. Scatton, Assistant to Secretary-Treasurer, North Carolina Licensing Board for Contractors, January 11, 1978.

Renewals

Licensed contractors are required by law to renew their licenses annually and pay a renewal fee of $35. Before 1972, contractors were required to submit renewal forms prior to December 31 of each year. Contractors licensed after 1972 are required to send in renewals during the month of original licensure. Although renewals were staggered by this change, approximately 30 percent (or 2,000) of the renewals still come in during November and December. As a result of this peak workload, the activity of the administrative staff increases for two months, and decreases in other months. A possible solution is to stagger renewal dates so the workload will be equalized throughout the year.

Beginning in November 1976, contractors were required to send in current financial statements in order to renew their licenses. The rationale for this requirement is that the financial status of a contractor can change drastically from one year to the next. The board is currently in favor of lowering the bid limits of contractors with financial problems, although they have not lowered bid limits in the past. They have not set up any criteria to aid in making decisions on lowering bid limits, and they emphasize that limits should be lowered only when there is a clear need, not just because a contractor has a bad year.

Although the procedure requiring financial statements is commendable, the board does not require the financial statements to be audited. Assets could easily be overstated, liabilities understated, or the statements otherwise prepared in a misleading manner. Requiring that all financial statements be audited every year would probably impose an unjustifiable burden on contractors. However, unless the statements are audited, the board has no assurance of their reliability except for the contractor's integrity. Many

contractors already submit audited statements. The board could obtain assurance of the validity of financial statements and otherwise ease the burden on contractors by periodically requiring that statements be audited.

The Board for Licensing Contractors has not reviewed any of the renewal financial statements submitted since they were first required in 1976. The board has an informal agreement with the Comptroller of the Treasury, Division of State Audit to review the financial statements of contractors. The state auditors calculate net worth and net working capital for each contractor, review the financial statements, and "red flag" those with problems for the board's attention. During calendar year 1977 over $20,000 was charged for these services; however, the results of the work have not been utilized. According to the executive director of the board, the renewal financial statements have not been utilized because of a shortage of personnel in the office of the board and a failure of State Audit to return the financial statements in a timely manner. The statements were not returned in a timely manner because of the lack of emphasis put on them by the board. The result has been that the statements have been filed away without the board's consideration, in effect wasting the $20,000 paid to the Division of State Audit to review them. Another result has been the approval of renewals without reviewing the financial statements, thereby granting license renewals to contractors whose financial positions may have changed. In these cases, if the financial statements had been examined, the board might have required further evidence of financial stability or lowered the license limits of some contractors.

A further difficulty with the current renewal procedure is that financial statements have been taken from the office of the board for review by State Audit, sometimes for extended periods of time. According to the executive

director of the board, it is often necessary to refer to those files which are removed from the office. The board has requested an Auditor III position for the review of financial statements in their office. This position was approved in the fiscal year 1978-79 budget. The auditor should save both money and time in reviewing the financial statements. However, to perform his or her job adequately the workload would have to be rearranged so that a manageable number of renewals were due each month.

ENFORCEMENT

The Board for Licensing Contractors only investigates complaints about unlicensed contractors, licensed contractors bidding on contracts over their bid limit, or contractors bidding in areas of construction for which they are not licensed. Most of these investigations stem from written complaints, telephone complaints, and Dodge Reports. Dodge Reports is a periodical which publishes construction projects up for bid, the contractors who bid on the projects, the bid prices, and the contractors who are awarded the projects. The board's investigator examines these reports to assure that contractors are properly licensed, classified, and within their proper bid levels. The emphasis of the investigative work is not on the quality of contractors' work.

In addition to investigating licensing violations, the investigator has attempted to inform municipal building and housing inspectors as to which contractors are required to be licensed by the state. According to the investigator, many licensing violations could be resolved by local building inspectors. TCA 62-621 states in part: "No official of the State, or any political subdivision thereof, shall issue a permit or contract work order to any applicant therefor, to do contract work, unless such applicant at the time holds a license as a contractor under the provisions of this chapter..." According to the board, cooperation by the building inspectors has been weak in the areas of issuing building permits to contractors who are not properly

licensed, and in the referral to the board of complaints about the quality of contractors' work. Improved cooperation and coordination of efforts between the board and the building inspectors could expedite the enforcement of the law.

TCA 62-617 stipulates that it is the duty of the board before granting a renewal to gather or receive satisfactory evidence that a contractor has paid all state, municipal and county taxes. The board presently requires a notarized statement from the contractor stating that all taxes have been paid; however, not all contractors have submitted these statements. The board has not verified the statements that were submitted or followed up on those that were not.

RATIONALE FOR LICENSURE

The construction industry's main characteristics are its low profit margin, competitive bidding, and its reaction to the trends in the national economy. All of these characteristics promote a high failure rate. It is theorized that the licensing of contractors protects the public welfare by qualifying applicants so they can better react to the economy and thus maintain financial responsibility. It is also postulated that the qualification of contractors promotes better quality work, and that the Board for Licensing Contractors serves as a forum for public complaints. Theoretically, the classification of contractors protects the public by assuring that the contractor possesses the minimum level of financial means, experience, and expertise to engage in the specific area of construction for which a license is sought.

How do these theories hold up in practice? First, the Board for Licensing Contractors does not effectively assure financial responsibility. The bid limits established by the Board are for per contract bids, and do not prevent a contractor from having ten or a hundred projects of that size in progress at one time. Also the procedure for arriving at those bid limits is questionable; it is not based upon any stated criteria and can be circumvented in several ways. Renewal financial statements have not been utilized by the board; consequently, contractors who might once have had sound financial positions could now have limits greater than their resources justify.

Second, the Board for Licensing Contractors presently does not assure the competence of contractors. The references contractors submit are not verified, the interviews are quite brief, and there are no minimum criteria established for either experience or financial responsibility. Further, although the board inspector is vigorous in seeking out contractors who are not licensed, in the past the board has not actively reviewed complaints regarding the quality of contractors' work.

Although the Board for Licensing Contractors is a group of dedicated individuals who have tried to protect the public as well as possible within the framework of the current law, the net effect of the operations of the board has not been the protection of the public. On the other hand, the public has not been adversely affected by the licensing of contractors. In essence the gains to the public from licensing have not been commensurate with the burden on contractors of complying with another set of government regulations. It is not clear what the effects of terminating the board would be; however, 22 states in no way license contractors.

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

Pouch Y, State Capitol
Juneau, Alaska 99811
(907) 465-3991

September 6, 1983

MEMORANDUM

TO: Representative Walt Furnace

FROM: David Teal
Legislative Analyst

RE: Licensed/Bonded Contractors
Research Request 83-213

Steve Levi, of your staff, asked whether or not Alaska had the least restrictive standards for licensed and bonded contractors. We contacted the Council of State Governments, the National Conference of State Legislatures and the Associated General Contractors of America to determine Alaska's standing in this regard. We discovered that training/experience requirements in Alaska are minimal relative to other states which require licensing and bonding of contractors, but that nearly half of all states do not require contractors to be licensed. Further, fewer than half of the 50 states require contractors to be bonded.

This memorandum discusses standards for contractors from three perspectives: when a licence is required; requirements for obtaining a license; and the consequences of failure to meet legal standards. Each of these topics is discussed below.

Who must obtain a contractors' license?

The attached table shows that 28 states require contractors to be licensed and that only 11 of those states require licensed contractors to be bonded.[1] From the perspective of whether or not a license is required to operate as a contractor, Alaska's standards are clearly more restrictive than those imposed by some states. However, relative to other states that require contractors to be licensed and bonded, Alaska is more liberal than some states. For example, no license is required for an Alaskan to repair his own property, while Arizona requires that work on personal property be performed by a licensed and bonded contractor if the building is rented or sold within one year of completion of the work.

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[1]The table is from a 1978 document prepared by the State of Tennessee. Much of the information appears to be outdated. More reliable information will be forwarded to you when it is received.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

JULY 2, 1974

Mr. Victor L. Lowe
Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Lowe:

This is in response to your request for comments on the draft report entitled "Surety Bonds in Federal Construction: A Study of Their Application and Effectiveness."

[See GAO note 1, p. 40.]

Operation of the Program

Before we get into the specific areas listed, we must bear in mind that the report itself is 14 months old, and we should like to provide an update on the statistical data listed in the report as of March 31, 1973, and bring that up to May 20, 1974. The Surety Bond Guarantee Program is the fastest growing program of the SBA. Following is a table indicating levels of activity:

CORRECTION

THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

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* * *

The Associated General Contractors of America has written a letter on this subject to each state. When results from that survey are available, they will be forwarded to your office. Previous work by the House Research Agency on the subject of contract bonding is attached to this memorandum. I hope you find the information useful.

DT

Attachments
Research Request 80-147
Exhibit I, State of Tennessee Program Evaluation

APPENDIX IX

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

JULY 2, 1974

Mr. Victor L. Lowe
Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Lowe:

This is in response to your request for comments on the draft report entitled "Surety Bonds in Federal Construction: A Study of Their Application and Effectiveness."

[See GAO note 1, p. 40.]

Operation of the Program

Before we get into the specific areas listed, we must bear in mind that the report itself is 14 months old, and we should like to provide an update on the statistical data listed in the report as of March 31, 1973, and bring that up to May 20, 1974. The Surety Bond Guarantee Program is the fastest growing program of the SBA. Following is a table indicating levels of activity:

Fiscal Year	No. Guarantees Approved	No. Contracts Awarded	Value of Contracts
1971 (Pilot)	21	7	$ 312,252
1972	2,316	1,339	$ 94,434,157
1973	8,657	5,597	$ 351,169,011
1974 (Thru 5/20/74)	11,856	8,150	$ 571,426,269
TOTAL	22,850	15,093	$1,017,361,689

The total number of contractors that have received this assistance since the inception of the program had been 8,342. There are 99 sureties that are currently participating in the program. Approximately 35 percent of our total guarantees are for minority contractors.

Next, we should like to outline the procedures through which an applicant goes in obtaining a surety bond guarantee: (1) The contractor obtains a copy of our application form from one of our district offices or, in most cases, through a broker or agent. (2) The original application goes directly to our surety bond personnel in the regional office, a copy to the surety, and an information copy to our local district office.

If an agent or contractor is unable to locate a surety willing to participate in our program in his area or feels that the sureties are unreasonable in their underwriting standards, our offices are prepared to give him a list of the sureties which have demonstrated a responsiveness to our program. Agreement with the surety industry provides that, if a surety decides that it cannot issue a bond even with an SBA guarantee, SBA will be supplied with the reasons for decline. Three major reasons for declination are:

1. The financial package is inadequately prepared,

2. The surety feels that the contractor does not have sufficient working capital to handle the contract under consideration, or

3. There is a lack of sufficient technical and/or managerial skills to perform the contract or to handle the extra managerial and financial load of one more contract in addition to his work in progress.

SBA can and does assist the contractor to eliminate deficiencies by the following means:

1. Refers the contractor to funded organizations which specialize in assisting the contractor in putting his financial package together properly.

2. Refers the contractor to SBA loan specialists for consideration of either a working capital loan or the revocable, revolving line of credit, which was designed specifically for construction contractors.

3. Refers contractor to our management assistance personnel.

If the surety decides that a bond can be issued with our guarantee, they will forward to our office a copy of the contractor's financial statement, together with a copy of our Surety Bond Guarantee Underwriting Review, SBA Form 994-B. The SBA Form 994-B is primarily a checklist of virtually all of the normal underwriting requirements that a surety would check out prior to issuing a bond, be it with SBA or on their own. Upon receipt of the Underwriting Review, the financial statement, and the surety's recommendation, the SBA makes its own underwriting review, and, if favorable, completes the guarantee agreement and returns it to the surety.

The following is an update on our claims and defaults. We compute our loss ratios on a quarterly basis, the last of which was as of April 20, 1974. At that time we had 548 default notifications, with 393 of these that have established incurred loss of $9,260,214. The incurred loss figure included paid losses plus reserves. In computing our loss ratios, we use our average sized contract of $68,000 and prorate the contract over a 10 month period. In other words, our $68,000 contract is 50 percent completed in 5 months and 100 percent complete in 10 months. Our loss ratio, based on completed commitments, is 1.24 percent.

SBA loss RATIO

The sureties compute their loss ratios on an earned premium basis rather than commitments. An average contract of $68,000 would carry a 1 percent premium. Therefore, the industry loss ratio, based on earned premiums, would be 124 percent versus 1.24 percent on commitments.

We break down our loss ratio by region as well as by surety. At any given time we can determine the loss ratio of a specific surety company, either nationwide or in any region.

All claims are handled out of our Central Office. Our field office sends us a copy of the complete underwriting file. A desk audit is made on each claim submitted. In addition to normal verification and audit of claims data, we also assure that the surety made no misrepresentations, etc., as well as attempting to establish reasons for default. We have found that the reasons our contractors go into default are basically the same as those that the sureties sustain under normal programs - insufficient capitalization to carry them over when they run into trouble, and going beyond their capacity. Only about 3 percent of our contracts go into default. Therefore, we have a success rate of 97 percent.

As a matter of information, we also have broken down some other statistical data with regard to our loss ratios. A study made by us in February shows the surcharge rate companies had a 1.56 percent loss ratio versus a 1.34 percent for the standard rate companies. This includes only those companies that have one or more losses. The commitments of the other companies are not included.

Minority contractors have established a 1.8 percent loss ratio versus non-minority at a 1.1 percent loss ratio. Our four largest producers in this program have the following loss ratios: 1.58 percent, 2.3 percent, 1.67 percent, 2.58 percent. These are all smaller companies that specialize in smaller contracts. One of the major companies, which is one of the largest surety bond writers in the country, has established a loss ratio of 1.60 percent in our program. A copy of the loss ratios is enclosed with this report and, as you will note, one company has a 7.5 percent loss ratio. However, there were only two claims that were quite substantial and would be considered as shock losses in determining loss ratio. We will debar any surety that has a consistent and inordinately high unexplained loss ratio.

.51% vs. 1.24% SBA

We have taken the position, unless Congress feels to the contrary, that a 2 percent loss ratio on commitments should be the maximum allowable in the program. This, we feel, is a reasonable loss expectation for the marginal contractor. As a comparison in loss ratios, GAO reports show that sureties have a 51 percent loss ratio on government work, based on their premiums. Converting this to our method of computation would show a .51 percent loss ratio on the "blue chip" contractors. Comparing this contractor to the marginal contractors that we are dealing with, our loss ratio of 1.24 percent would fall in line with the intent of the program.

Need for Increased Participation by SBA in Program Operations

Our position is that any contractor who meets our size standards is eligible to apply for surety bond guarantee assistance. The initial evaluation of the contractor is up to the surety. The premiums charged by sureties include efforts expended in the prequalification of contractors. This is a function that we feel should be performed by the surety itself. Our function is only reviewing what the surety has submitted to us and to see whether it falls in line with our legislative and regulatory requirements. The industry itself does not have any iron-clad formal underwriting criteria. Each case must stand on its own merits. We feel this same procedure should be followed within our own program. However, we do have our underwriting review, which is an official checklist for the industry of the information we expect them to develop in order to make an underwriting determination. As we have mentioned earlier, should a surety decide that a contractor does not qualify for a bond, even with an SBA agreement, and, if we feel that the contractor can perform, we will refer him to a more responsive surety.

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One factor which makes it difficult to establish formal underwriting guidelines for the sureties is that these guidelines can be used to turn down applicants, as well as to make them eligible. As a rule of thumb, for construction contractors, many sureties require a ratio of 1 to 10 of the contractor's net quick assets to his total work in progress. There are cases where the surety may want a 1 to 5 ratio. There are other cases where another surety may go 1 to 20 on a specific contractor. Availability of additional credit, size of the job, and the amount to be subcontracted are all elements that enter into a decision on net quick asset requirements. If we were to establish a standard of, say 1 to 15, a ratio of less would automatically trigger a decline by the surety industry. It would become too complex to establish these types of standards. The industry itself has general guidelines in their normal underwriting; we expect them to use their guidelines, consider that these are marginal contractors, and that the SBA will accept risks that the industry would normally decline. All we ask them to do is to give us the normal underwriting data with all of the facts and their opinion as to whether the contractor can perform the specific contract. Based on that analysis, SBA will further analyze the facts presented and make a subjective judgment.

We have even had cases where we have extended our guarantee where the contractor had a deficit net worth and where he performed successfully. However, we could not write a guideline that would permit the issuance of a guarantee to a contractor with a deficit net worth. Such a determination would depend upon the individual contractor and circumstances of the specific case.

A contractor has every right to appeal to SBA for assistance should he be turned down by a surety, and, as a matter of fact, frequently does. We have met with several minority contractor associations throughout the country. There is a favorable consensus among these groups.

The question of "graduation" is a difficult one. The sureties do not notify us when they take a contractor out of our program and put him into their own. The only assumption we can make is that, if there is no activity in a particular file for 6 months to a year, we can assume that the contractor, if he has not gone into claim, has gone into the surety's normal business. We do, however, have certain guidelines for our surety bond personnel in the field. As an example, a valid reason for keeping a contractor in our program after he completes several jobs could be that his financial statements show insufficient earnings to justify bonding him without SBA support. Another reason is that the contractor is increasing the size of job or total work program beyond what the surety would accept in its standard business. Again, this is a form of graduating from small contracts to larger contracts.

There is considerable room for upward mobility within the program. The average job is now $68,000. Our limit is $500,000. We also find that the marketplace itself assists in this area. We have noted that even in the cases of some surcharge rate companies, which may not write standard rate bond business, a contractor who can qualify for standard business will go with one of the major companies. The reason for this is twofold:

(1) The contractor will not pay the higher premium if he can avoid it, and

(2) There is a certain pride among contractors when they can get bonding on their own with one of the major sureties.

We must remember that the contractors in our program are considered marginal and no contractor wants to be tagged with that label for any longer than absolutely necessary. In checking with one of the large producers in the surcharge rate area, we find that they average 1-1/2 contracts before they lose a client to one of the other surety companies. Our national average is less than two contracts per contractor since the inception of the program.

When we originally discussed the prospects of this program with the industry, one of the objections of the industry in handling our type of business - the marginal contractor - was the fact that the administrative expense alone, aside from the losses, would be far greater than the normal business. Our experience so far has proven this to be the case.

In February we had a meeting with 19 surety companies, each of which write 1 percent or more of our total volume. Combined, they represented 89 percent of the total volume in our program. Also attending were representatives of the American Insurance Association, the Surety Association of America, and the Agents' Associations. The purpose of the meeting was to discuss premium sharing, percentage of guarantee, and contractors' fees.

The major companies expressed a willingness to increase the SBA share of the premium and to consider a reduced guarantee percentage. They also stated that they were losing money on the program. Our analysis of their activity would bear this out.

The smaller companies took a very strong position on maintaining the present fee and guarantee structure. They stated that they were making money on the program, that increased fees and decreased guarantees would eliminate profit, and that without profit they would not remain in the program.

There are many factors to consider. Why are the major companies willing to participate in the program at loss? Is it because their big business clients are applying subtle pressure to eliminate competition? Is it because they know that the smaller sureties cannot remain in the program at a loss?

To remain in the program with higher fees or a lesser guarantee, the smaller sureties would have to tighten up on their underwriting. What would the effect be on the minority contractor? The loss rate on his business is 1.8 percent versus 1.1 percent for nonminority. With a tightening of underwriting standards, the benefits of the program would be denied to those who need it most.

We are not prepared to adjust either the fees or percentages of guarantee at this time. We will, however, make adjustments at such a time as our continuing analyses might justify.

We are enclosing a list of all the sureties participating in our program as of May 20, 1974 (from the inception of the program). This list includes the number of contracts and the dollar values by region and total. As you will note, there are many sureties listed that are national companies but have written very few bonds through our program in the almost 3 year period since its inception.

The report also states that the maximum allowable premium rate that SBA permits was $20.00 a thousand and a change to $15.00 a thousand under contemplation. Our maximum allowable rate as of March 1973 is $15.00 per thousand for the first $50,000 and $10.00 per thousand on amounts in excess of $50,000. Therefore, we only allow the additional 1/2 percent on the first $50,000. Any surety that is using the standard 1 percent in their normal business, because of filing with the various state insurance departments, must use the same rate for the business with the SBA program. Therefore, there are very few companies charging the 1-1/2 percent rate, though it is true that a substantial amount of our volume comes from sureties which charge the higher rate. We have no quarrel with those sureties which are in the program for profit. Profit, if kept within reasonable bounds, is a perfectly legal and proper incentive.

Lack of Incentives

Our experience in the program alone seems to dispute this point.

1. For the surcharge rate companies, their records show that a contractor, on the average, has 1-1/2 contracts prior to leaving them.

2. The total number of contracts in the program versus the number of contracts guaranteed is still less than two contracts per contractor.

It is true that the surcharge rate companies would prefer to keep the contractor with them for a longer period of time, but, because of market conditions and the lower rates with the standard surety companies, the contractor automatically will go where the price is right. It must also be noted that publicly the Surety Association and American Insurance Association have indicated to us that they feel the program is getting too large. Therefore, they are encouraging their members to graduate contractors out of our program and write them in as their standard business. This philosophy of the industry is understandable. They are afraid of any government interference in the surety bond field. Total underwritings through the SBA are probably between 1 to 2 percent of the total value of construction bonds written throughout the country, and it is evident that they do not want government participation to become a much bigger factor than it now is.

We have found no instance where the surety found that it was advantageous, economically or administratively, to allow the contractor to default rather than provide financial and technical assistance. On the contrary, the sureties check with us on all claims and we work together in attempting to handle claims in the best way possible. There are many cases where the sureties have financed the contractor. When the surety finances the contractor, we do not provide any funds to the surety while they have the funds in a controlled account. However, once the funds are expended from the account, then the sureties receive their 90 percent reimbursement. This is much the same way that claims are handled between the sureties and their reinsurers. So again, we have found no cases where the surety has defaulted a contractor rather than go through additional administrative expense in trying to have the contractor himself complete the job. It is an unfortunate fact that, once a marginal contractor defaults, the chances of his survival are minimal. In a few cases, however, through the mutual efforts of SBA and the surety, we have been able to help a contractor so that he corrected his default and was able to continue in business.

Conclusions

Based on the information given herein, we feel that we have covered the three points in your recommendations:

[See GAO note 1, p. 40.]

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

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MEMORANDUM July 1, 1980

TO: Representative Patrick O'Connell

FROM: Anne DeVries, Issues Analyst AD

RE: Availability of Contract Bonding
Research Request No. 147

This memorandum is in response to your request for research on the availability of contract bonding for small contractors. I understand you are interested in possible legislative action to relieve the problems some contractors face in obtaining contract bonds in amounts over $500,000.

Summary of Findings

Briefly, there are three major findings from this research:

- Overall, contractors are able to get bonding in the amounts for which they are qualified. It is not evident that sureties are denying bonds to contractors on the basis of criteria which are irrelevant to their ability to complete a contract.

- A State reinsurance program is the major way in which bonding could be made more available. The primary problem of such a program is that it would expose the State to financial losses on defaulted contracts.

- The availability of bonding is important to contractors because bonds are required for most public works contracts. An alternative to making bonds more available is to modify access to public contracts. The State has two main alternatives: to raise the amount of the contract below which no bonding is required, or eliminate bonding altogether. There are two problems with these alternatives: they expose the state to financial losses from defaulted contracts and they shift the responsibility of determining contractor qualifications from a non-political body, the surety, to the State. These are the same problems that the surety system was designed to eliminate.

Introduction to the Question of Bond Availability

Contract bonding is the way in which a corporate surety, usually a large insurance company, extends its financial backing to qualified construction contractors. It is a means of assuring the construction client that he will not have to suffer a financial loss because the contractor fails to complete a contract. The demand for bonds arises primarily from the public sector as bonds are a means of protecting the taxpayer from contract losses.

In return for a service fee, a surety company will bond any contractor it deems qualified to do the work for which a bond is required. If the contractor defaults on the job, the surety is obligated to assure that the contract is satisfied with no financial loss to the client. If the surety incurs a loss in meeting its obligation to the client, it will take action against the contractor to recover its losses. Under established surety underwriting practices, the risk of financial loss from default remains with the contractor. As a consequence, the surety will bond only those contractors in situations where it anticipates that no default will occur, and where the contractor is financially able to cover any losses that may occur (if, for instance, where one of the principals dies and the firm cannot complete the contract). The availability of bonding, therefore, is determined by the criteria surety underwriters use to define a "qualified" contractor.

Interest Groups

The question you have raised concerning the availability of contract bonding directly affects the economic interests of four groups, often in conflicting ways. The interests of these groups - the contractors, the sureties, the construction clients and the State - are described in this section.

The Contractors: As a group, contractors share two interests:

- They desire ready access to work, and to the extent that the lack of bonding denies access, they want ready access to bonding as well.

- They would like to limit competition to qualified contractors. An unqualified contractor may be the low bidder because he lacks full knowledge of costs and potential problems in a job. He may get a contract and then fail to perform. This creates "unfair" competition to qualified contractors.

Obviously, those contractors who have no trouble obtaining bonds do not necessarily see their interests enhanced by measures making it easier for other contractors to secure the same means of access to work.

The Sureties: As a group, sureties share an interest in making money. However, there are two types of surety companies with distinctly different ways of making money:

- Standard sureties make money by writing all the bonds they can. However, as they are not compensated for risk, they adhere to underwriting criteria that are established based on the presumption of "no losses".

- Specialty sureties make money by exploiting the government subsidy inherent in the Small Business Administration's re-insurance program. This is discussed in greater detail later in the memorandum.

The Construction Clients: Demand for bonding originates primarily from the public sector, all discussion in this memorandum will focus on the interests of municipal, state and federal construction clients. As a group, these entities share two interests:

- They want to protect the taxpayers' interests by obtaining the best quality construction work at the lowest price.

- In order to insure the lowest feasible costs, state and federal governments want to insure adequate competition among qualified contractors by removing any artificial impediments to competition, such as minority discrimination.

- They want to protect themselves from the claims of suppliers or laborers who were not compensated by a contractor on a public works job. Bonds are necessary as public works are not subject to liens designed to protect suppliers and laborers on private jobs.

The State: The State, as a protector of its citizens, wants to:

- Insure that citizens are not prevented from enjoying their livelihoods by the arbitrary acts of others, such as a private company discriminating against minorities.

- Insure that citizens have "fair" access to all work that the state provides.

Of these four parties, the State faces the strongest conflicting interests. It may want to make access to bonding easier in order to insure some of its citizens better access to their livelihoods, while at the same time it is the largest single beneficiary of the contract bonding system. This conflict will be the focus of this memorandum.

What is Contract Bonding?

Construction is an inherently risky business. A contractor can fail to perform on a job for any number of reasons:

- Key personnel die or become disabled, either physically or emotionally - a divorce or death in the family, a drinking problem, etc.
- He is overextended; either he has committed his firm to too much work or to a job which may have unexpected problems beyond his capability to solve.
- He has inadequate supervision.
- He has an inefficient operation.
- He lacks the appropriate job cost accounting records and procedures.
- He has uninsured losses.
- He is the victim of employee dishonesty.
- He has submitted an improper bid: it may contain mistakes, it may not allow for unforeseen contingencies and/or price increases, or it may not have adequately provided for overhead.
- He has failed to arrange proper financing.
- He has made a poor selection of venture partners.
- He is adversely affected by weather conditions.

Awarding a contract to the "lowest qualified bidder" increases the risks of a project, for the contractor who wins the job has given himself the smallest possible financial cushion with which to absorb the cost of any problems.

The construction client recognizes that these problems can occur and he has two alternative ways to protect his interests:

- If a contractor fails to perform, the client can arrange to complete the job himself and take legal action against the contractor.

- He can require that the contractor secure the backing of another party who will assure the client that he will suffer no financial loss from a contractor failure. This third party may be an individual or a corporate surety.

Under either alternative, the client pays for the cost of this protection. In the former instance, he incurs the costs directly; in the latter, the cost of the surety's bond is included in the bid price.

Types of Bond Required: Three types of contract bonds are generally required:

Performance bonds guarantee that the work will be completed in accordance with the plans and specifications and at the contract price.

Payment Bonds guarantee that the suppliers and employees of the contractor will be paid. Payment bonds are required on all public works projects because that property cannot be made subject to a Mechanics and Materialmen's Lien which protects these interests on private projects. A payment bond also makes it easier for suppliers to get credit, as they are assured of being paid.

Bid Bonds guarantee the sincerity of the bid. A bid bond in the amount of 10% to 25% of the bid is usually required. If a contract is awarded to a bidder who is then unable to secure the other required bonding or for some reason cannot enter into a contract, the bid bond is forfeited. A surety will usually issue a bid bond only when it is prepared to issue payment and performance bonds, as required.

Both payment and performance bonds are required because it is possible for a contractor to finish a job and then "leave town" before his suppliers and employees are paid, or he might meet his obligations to his suppliers and employees without satisfactorily completing the job.

Underwriting Requirements: The surety decides whether or not to provide bonding to a contractor through a careful analysis of his job history and financial capacity. This process is termed underwriting. It is underwriting which determines the availability of contract bonding.

There are two major factors considered in underwriting:

- The total amount of work the contractor will have if he is awarded the contract for which a bond is required.

- A combination of his performance record, his experience with the type of work required by the contract, the suitability of his equipment and the skill of his employees for the type of construction, the soundness of his bid and his financial capability.

The contractor will usually be asked to supply his bond agent or broker with the following:

- Financial statements for the last three years. Depending on the size of the job and the surety, these statements may have to be prepared by a certified public accountant and may have to be auditied.

- Completion of a contractor questionnaire which requires resumes of experience — job size, client, etc.

- A letter from his banker stating his credit experience with the contractor - what credit has been extended, how it has been handled, what credit is available for the upcoming contract, etc.

- Two or three letters of recommendation from former clients.

- One to two letters of recommendation from major suppliers.

An underwriter evaluates two aspects of the contractor's financial status: the amount of working capital he has in relation to the dollar volume of his projected workload and his net worth. Sufficient working capital is necessary to cover cash outlays for which the contractor will be reimbursed later. Contractors are usually paid on work as it is completed, therefore they must finance each portion of the work themselves. In addition, clients retain a portion of the payment, usually 10%, until the project is completed in order to guarantee performance. The contractor has to finance that 10% for the duration of the project. Without adequate working capital, a contractor may have to stop work on the project and be in default on the contract. A contractor's net worth, total assets less total liabilities, is the second component of his financial status that is important to a surety. The surety relies on a contractor's net worth as the primary loss paying fund, should the contractor default on the contract and the surety incurs losses in completing the contract.

Cost of Bonding: Contractors are charged a premium for the bonds they are issued. The premium is determined by the amount of the bond, the duration of the bond obligation and the type of contract being bonded: as the amount of the bond increases, the cost per thousand dollars of bonding declines; as the duration of the bond obligation lengthens beyond a specified period, the cost of the bond increases; and as the complexity of the construction task increases, the cost of the bond increases. The Surety Association of America has established rates which are used by most standard sureties; in its rate setting manual, it divides construction contracts into three major groups:

Class B	These are the most difficult types of construction involving architectural building construction, most engineering construction, concrete and excavation work performed underground or in or under water, etc.
Class A	These are general contracts and subcontracts of generally less difficult nature than those included within Class B such as most earthmoving work of a non-excavation nature, etc.
Class A-1	Contracts of this description include those generally less difficult than "B" or "A" of the construction classification and contracts for furnishing and installing, or installing only, or providing various services and equipment, such as a data processing contract.

As an example of the rate structure, the premium established for a Class B contract is 1.2% of the contract amount under $500,000, .725% of the next $2,000,000; .575% of the next $2,500,000; .525% of the next $2,500,000; and .48% for any additional amounts. This covers a bond obligation of 24 months.

The premium charged by a surety is distinctly different from that charged by an insurance company. The surety premium is not meant to create a loss-paying fund as an insurance premium does. In insurance, risk is transferred to the insurer, whereas in bonding that risk remains with the contractor. The function of a premium is clearly stated in the following excerpt from a Surety Association of America publication:

> Suretyship transaction does not intend a transfer of risk from the contractor to the surety. .... The surety's obligation is collateral or secondary to the contract obligation assumed by the contractor.. The surety's fee is essentially a flat rate charge for the services performed by the surety and as such it is more related to averting or controlling loss than to funding ultimate loss."
>
> The Unseen Services of a Surety, Surety Association of America

Reinsurance and Cosuretyship: A surety has two options for limiting his exposure on a contract bond: reinsurance and cosuretyship. Reinsurance is a means of sharing the premium and risk with another company; and it is a standard practice in the industry. The most commonly used mechanism is for the reinsurer to take a percentage of the premium (net of commission) and to assume the same percentage of any loss. The SBA program is a form of reinsurance; however, the government assumes a disproportionately large share of the risk for the premium it receives.

Cosuretyship is the means by which two or more sureties jointly issue a bond. Each surety has a limit on the amount of single bond it can write, depending on its financial position; this limit is established by the U.S. Treasury. By jointly issuing a bond with another surety, a surety can bond a contractor for an amount greater than the Treasury limit of either surety. Most cosuretyship arrangements limit the liability of each surety to a specified amount.

Regulations Pertaining to the Contracting Industry

The following sections outline the State's requirements for entry into the contracting business and its requirements for bonding on public works contracts.

There are about 3,000 contractors licensed by the State to operate in Alaska. About half of these are general contractors, the remainder are specialty contractors.*

According to AS 8.16, in order for a construction contractor to operate in the state, he must be issued a certificate of registration by the Department of Commerce and Economic Development. The following are required before a certificate is issued:

- a completed application
- a registration fee of $100 for a general contractor and $50 for a specialty contractor
- a surety bond of $5,000 for a general contractor and $2,000 for a specialty contractor or an equivalent cash deposit
- public liability and property damage insurance no less than $20,000 for property damage, $50,000 for injury or death to one person and $100,000 for injury or death to more than one person.

The surety bond, also termed a "license bond", is intended to assure payment of:

- all taxes and contributions due the state and political subdivisions
- payments to all persons furnishing labor or material or renting or supplying equipment
- payments for all amounts that may be adjudged against the contractor by reason of negligent or improper work, breach of contract or damage to public facilities occurring in the course of a construction project.

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* AS 8.18 defines a contractor as "a person who, in the pursuit of an independent business, undertakes or offers to perform, or claims to have the capacity to perform, or submits a bid for a project to construct, alter, repair, move or demolish a building, highway, road, railroad, or any type of fixed structure, including excavation and site development and erection of scaffolding; a "general contractor" is a contractor whose business operations require the use of more than two distinct trades whose work the general contractor superintends." A specialty contractor is one involved in only one or two distinct trades.

In addition to this bond, the State requires payment and performance bonds on construction work exceeding $50,000 in value. AS 36.25 establishes the minimum bond coverage; the contracting officer is empowered to increase these amounts as he sees fit. The bond requirement can be satisfied by either a corporate surety, a large insurance company, or by two individual suretis who "shall each justify in a sum equal to the amount of the bond". The relevant portions of the statute are quoted below:

> . . . before a contract exceeding $50,000 for the construction alteration, or repair of a public building or a public work of the state or a political subdivision of the state is awarded to a general or specialty contractor, the contractor shall furnish to the state or political subdivision of the state the following bonds, which become binding upon the award of the contract to that contractor.
>
> (1) a performance bond . . . .; the amount of the performance bond shall be equivalent to the amount of the payment bond.
>
> (2) a payment bond . . . for the protection of all persons who supply labor and material in the prosecution of the work provided for in the contract; when the total amount payable by the terms of the contract is not more than $1,000,000, the payment bond shall be in a sum of one-half (50%) the total amount payable by the terms of the contract; when the total amount . . . is more than $1,000,000 and not more than $5,000,000, the payment bond shall be in a sum of 40% of the total amount . . .; when the total amount . . . is more than $5,000,000 the payment bond shall be in the sum of $2,500,000.

The statute also provides for a municipal exemption which allows municipalities to exempt contractors from these bonding requirements on contracts not exceeding $400,000 if the following conditions are met:

- The contractor has been licensed in the state for a period of two years and his principal office is in the state.
- The contractor has certified that he has not defaulted on a contract awarded to him during the previous three years.
- The contractor submits a financial statement, prepared within a period of 9 months preceding the submission of a bid, . . .

certified by a public accountant . . . demonstrating that the contractor has a net worth of not less than 20% of the amount of the contract for which the bid is submitted.

- The total amount of all contracts which the contractor anticipates performing during the term of performance of the contract for which a bid is submitted does not exceed the reported net worth by more than seven times.

The Federal statutes, the Miller Act, served almost verbatim as a model for the State statute. There are only two differences: the Federal government requires bonds for all contracts in excess of $2,000 and it leaves the amount of the performance bond to the discretion of the contracting officer.

While the State statute requires a combination of payment and performance bonds amounting to 100% of the contract amount on jobs under $1,000,000, 80% on jobs between $1,000,000 and $5,000,000, and a flat bond of $5,000,000 on jobs over $5,000,000, in practice 100% bonding is required on all projects over $50,000. On projects which involve federal money, a 100% performance bond and a 100% payment bond is usually required. Municipal practices differ with the municipality and the source of funds it is spending; however, they are usually at least as strict as the state practices.

The Alaska Bond Market: Contracts bonds are supplied by 71 companies licensed to do business in Alaska. All are regulated by the Division of Insurance of the Department of Commerce and Economic Development, to which they must submit their premium rates for approval.

There are three types of firms: the standard companies, the specialty companies which are involved in the SBA reinsurance program, and sub-standard companies. This last group is able to supply bonds for the most marginal contractors by charging higher rates. It is not a significant part of the market.

The standard companies dominate the bonding market. The four largest companies, Travellers, Firemen's Fund, Fidelity and Deposit of Maryland, and Safeco, control over 50% of the Alaska market. Forty-nine companies, each writing less than $50,000 in premium annually, account for only 5% of the market.

In 1978, the last year for which data is available, $5.6 million of

direct premiums were written for surety bonds on Alaskan construction. Premiums average about 1% of the bond amount, so approximately $562.6 million of construction jobs were bonded. Direct losses to surety companies, net of recoveries, were $0.2 million, or 4% of the premiums written or .04% of the construction activity. The table below summarizes bonding activity since 1974.

TABLE 1

Surety Bonding Activity in Alaska, 1975 - 1978

	1975	1976	1977	1978
Number of Companies	93	70	68	71
Direct Premiums (000)	$3950.5	$4178.0	$4442.0	$5626.0
Direct Losses (000)	$1838.7	$ 964.0	$2863.0	$ 209.0
Losses/Premiums	47%	23%	64%	4%

Source: Insurance Reports for 1977-1979, issued by the Department of Commerce and Economic Development, Division of Insurance.

As you are aware, some small contractors have noted a tightening in the availability of bonds. They are unable to get the same levels of bonding that they have gotten in the past or they are unable to find sureties willing to write larger bonds for them. Apparently, they are experiencing the impact of tighter underwriting standards which have been made necessary by the large losses the sureties suffered in the mid-1970's, as indicated on Table 1; normal surety losses average between 5% to 10% of premiums while losses in Alaska got as high as 64% in 1977. One surety termed Alaska the "cemetery" of surety companies.

According to members of the industry who have followed the developments in the Alaska market, underwriting standards by most sureties were relaxed in the early 1970's in response to competitive pressures. Sureties are in the business of writing bonds and the primary limitation on the amount of bonds they write is their underwriting criteria. In

the late 1960's, a company entered the Alaska market agressively seeking business by writing bonds more readily than the existing companies. It offered larger bonds and larger bonding capacities to firms in order to take business away from competitors. The other companies were forced to match its tactics in order to retain customers. By the mid-1970's, this company, which had followed the same strategy across the country, was incurring large losses and decided to leave the surety business.

The problem of losses due to loosened underwriting standards was exacerbated by the recession in the mid-1970's. High interest rates affected a contractor's ability to get financing and inflation adversely affected his ability to project costs for materials and labor; both could lead to default on a contract.

As a response to these problems, some sureties chose to leave the Alaska market, while the remaining ones revised their underwriting criteria. One broker characterized this as a return to normal underwriting practice after a period of too-loose underwriting. He noted that the market in Alaska is "coming back". The current market has been characterized as the best one in Alaska for years; the comment that "any qualified contractor can get bonding" was made repeatedly by the surety representatives interviewed.

Means of Increasing Bond Availability

It is the question of what constitutes a "qualified contractor" which is central to the issue of availability. For the client, bonding serves a twofold purpose: it protects him from financial loss and it is a means of pre-qualifying contractors who want to bid on work. The client is protected by the surety's financial stake in only bonding qualified contractors. Because contract bonding is both a form of credit and a pre-qualification process, there are always some contractors who are unable to secure bonding for jobs which, in the opinion of the surety, exceed their financial or technical capability. Consequently, it is impossible to judge whether the contractors who have been experiencing problems in bonding are being subjected to unfair discrimination or are simply not sufficiently qualified to warrant the surety's financial commitment. If, through additional extensive research, it is found that there is some significant pattern of discrimination against a particular type or class of contractor, the State has two types of approaches to relieve their dilemma:

- It can permit sureties to lower their underwriting standards by assuming a large share of the risk of contractor defaults.

- It can remove the bonding requirement, on all jobs or on jobs over a certain amount, and assume the surety's dual functions. The State would be responsible for recovering its own losses on contractor defaults and it would have to devise a means of pre-qualifying contractors. These qualifications could reflect preferences to particular types of contractors if it could be shown they had been excluded unjustly from work because of surety discrimination.

There are variations on these approaches; however, these are the two major ones which have been considered by the Federal government in its frequent reviews of the surety bonding process.

Again, I have been unable to conclude that any group of contractors has been denied bonding for reasons unrelated to their ability to perform. As a third-party, often the State of Alaska, relies on bonding to protect the taxpayers and simplify its contracting process, it would seem that such a pattern of discrimination would have to exist before the State encourages the lowering of underwriting standards or becomes its own surety. That reservation aside, the following section describes how the Small Business Administration's reinsurance program works. This is the type of program which the State could implement if it choose the first of the two alternatives listed above.

The SBA Program

The Small Business Administration manages a program of reinsurance for contractors with annual gross sales of less than $3.5 million who are unable to get bonding with a standard surety company. The SBA program will issue a bond up to $1 million. The average SBA bond in the Pacific Northwest Region is about $70,000. This program was originally intended to help minority contractors secure bonding. It has since been expanded to include all small contractors as a way to insure their access to the bond market, and hence to public construction jobs.

The standard market takes the theoretical approach to surety bonding - it bonds contractors assuming there will be no losses and charges a premium, not based on risk, but to cover the costs of offering the service. On the other hand, the sureties which spcialize in SBA bonds - the specialty

market - are more liberal in their underwriting criteria because the federal government is subsidizing the defaults of less "qualified" contractors who are bonded through the program.

The contractor pays a higher price for SBA bonding than he would if he qualified for bonding in the standard market. Table 2 presents a comparison of the premiums charged for bonds of different amounts under the standard surety rates and the SBA rates. The standard surety charges 1.2% of the contract amount for the first $500,000 and .0725% for up to the next $2,000,000 of bonding. In return for this premium, the surety is obligated to the full extent of the contract amount. These are the maximum rates charged for the most risky class of contract according to the Surety Association of America rate filing.

For the specialty surety, the maximum premium is 1.5% on amounts less than $250,000 and 1.0% on the balance of the bond. In addition, the SBA charges .2% of the contract amount as a service fee. Therefore, on a $250,000 bond issued by the SBA, the contractor pays 1.7% of the contract amount, compared to 1.2% for similar standard bond. The surety retains 80% of the premium and the remainder goes to the SBA. For its 80% premium, the surety takes 20% of the risk of default (10% if the bond is less than $250,000). The SBA assumes 80% of the risk of default (90% if the bond is less than $250,000) and receives 20% of the premium and the .2% service charge.

The SBA makes it attractive for sureties to bond contractors through its program by taking a disproportionately large share of the risk for the premium it receives. Table 3 illustrates the cost of this reinsurance program to the SBA. Table 3 assumes a 1.25% loss rate on each bond; this is the loss experience for the Pacific Northwest over the life of the SBA program. This loss is divided between the surety and the SBA and then compared to the premium income each received. For instance, on a $500,000 bond the loss is assumed to be $6250 or 1.25% of the bond. The SBA would cover 80% of that, or $5000. In issuing this bond the SBA received $1250 in premium and $1000 in service fees, a total of $2250. The SBA incurs a loss/premium ratio of 225% by assuming the larger share of the risk while the specialty surety has a more moderate 25% loss ratio. Overall, the loss ratio is 86.2%. This compares unfavorably with the national average of 5% to 10% and the most recent Alaskan performance of 4%. Table 3 also illustrates why some contractors have trouble getting SBA bonding over $250,000. The loss ratio doubles on these larger bonds because the government is assuming less of the risk; therefore, the specialty sureties have lost some of their incentive to take chances on weaker contractors.

Standard sureties, the ones writing the majority of the business in Alaska, generally do not participate in the SBA program. They have a number of objections to it:

- The paperwork demands are great. A contractor has to be underwritten each time he wants a bond. This requires the compilation of financial statements, letters of recommendations, etc. for each bond application. A standard surety avoids this problem by establishing a bond capacity, good for up to a year, on which the contractor can draw.

- Paperwork requirements create time delays. For instance, bonds over $500,000 must be approved by the SBA's Washington D. C. office.

- The SBA duplicates the underwriting work of the sureties to some extent.

- However, the overriding objection to the program is that "unqualified" contractors are placed in competition with "qualified" contractors, those who got bonding in the standard markets. Standard sureties see themselves as applying one standard to a contractor - whether or not he can complete the job - if the contractor can not mmet this standard, then he should not be given bonding.

It is likely that a State program similar to the SBA's would face similar problems: duplication of work done in the private sector, creation of a bureaucracy, the resistance of standard sureties, etc. However, the two most important problems it would face are:

- the cost of defaulted contracts, and

- the difficulty of defining limits to the program

These are clearly related. The SBA program began to help minorities, the victims of racial discrimination. It was expanded to help all "small businesses" and is under pressure to increase its limits to raise the definition of "small". A state program would be faced with a similar dilemma of pressures for an ever expanding scope. And clearly, financial losses from defaulted contracts would be a function of how broadly the State defined the group of contractors worthy of subsidy and the extent of the subsidy it offered.

It has not been possible to provide an extensive analysis of the SBA program within the time frame of this research. The detailed questions which would require answers before any State program is considered, are:

- Why are contractors in the SBA program unable to get bonding elsewhere? (Minorities excluded)
- Why is the loss ratio so high? How does this relate to the composition of contractors in the SBA program?
- How many contractors are able to grow out of the SBA program into the standard surety market?
- What are the administrative costs of the program?
- Based on a range of assumptions about the scope of the program, the amount of the risk assumed by the State and loss experience, what are the potential costs to the State?

Modifications of Bonding Requirements

The State has another alternative way of addressing the problems some contractors face in obtaining bonds, and hence access to public work: it could eliminate all bonding on State jobs or it could increase the contract amount below which no bonding is required. There are two problems with this approach. First, the State would have to duplicate the capabilities of existing sureties. It would require personnel to arrange for the satisfactory completion of contracts in default and to bring legal action against defaulting contractors for any losses it incurred. In addition, it would require the development of criteria to determine which contractors were qualified to bid on State contracts. One of the reasons for the creation of the surety system was to remove the "qualifying" process from the potential distortions of the political process. If the State became its own surety, on some or all contracts, its loss experience would primarily be determined by the appropriateness of its qualifying criteria in relation to contract requirements.

As this memorandum has shown, underwriting is a subjective process. It has been impossible to determine, within the time frame of this work, whether any conditions exist which limit bonding available in a way that warrants action by the State to increase availability of bonding. The standards that sureties established are intended to protect the client,

notably the State of Alaska, and any actions to change underwriting standards to increase availability may create serious problems for the State. I will send shortly selected portions of a report to Congress on the surety industry and its effect in preventing contract losses to the federal government. This may be of interest to you. If you have any additional questions, please let me know.

AHD/bf

COMPARISON OF LOSS/PREMIUM RATIOS FOR THE SPECIALTY SURETY AND THE SBA

	BOND AMOUNTS				
	$249,999	$250,000	$500,000	$750,000	$1,000,000
SPECIALTY SURETY					
-Loss	312	625	1,250	1,875	2,500
-Premium	3,000	3,000	5,000	7,000	9,000
-Loss/Premium	10.4%	20.8%	25.0%	26.8%	27.8%
SBA					
-Loss	2,812	2,500	5,000	7,500	10,000
-Premium	750	750	1,250	1,750	2,250
-Service Charge	500	500	1,000	1,500	2,000
-Premium + Service Charge	1,250	1,250	2,250	3,250	4,250
-Loss/Premium + Service Charge	225.0%	200.0%	222.2%	230.8%	235.3%
OVERALL					
-Loss/Premium + Service Charge	73.5%	73.5%	86.2%	91.5%	94.3%

House Research Agency

July 1, 1980

TABLE 2

COMPARISON OF STANDARD AND SPECIALTY SURETY RATES

	BOND AMOUNTS				
	$249,000	$250,000	$500,000	$750,000	$1,000,000
STANDARD SURETY					
Surety's Premium[1]	3,000	3,000	6,000	7,813	9,625
Exposure	249,999	250,000	500,000	750,000	1,000,000
Cost to Contractor	1.2%	1.2%	1.2%	1.0%	1.0%
SPECIALTY SURETY					
Total Premium[2]	3,750	3,750	6,250	8,750	11,250
SBA's Premium[3]	750	750	1,250	1,750	2,250
Surety's Premium[4]	3,000	3,000	5,000	7,000	9,000
Surety's Exposure[5]	25,000	50,000	100,000	150,000	200,000
SBA's Exposure[6]	249,999	200,000	400,000	600,000	800,000
Cost to Contractor[7]	1.7%	1.7%	1.5%	1.4%	1.3%

For Class B contracts: 1.2% for 1st $500,000, 0.725% for next $2,000,000 per the Surety Assoc. of America rate filing.

Maximum premium of 1.5% on 1st $250,000, 1.0% on amounts over $250,000 per SBA fact sheet.

20% of the premium.

80% of the premium.

10% for bonds less than $250,000, 20% for bonds equal to or greater than $250,000.

Balance of the contract amount.

Include 0.2% for SBA service fee on all bonds.

House Research Agency

July 1, 1980

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

Pouch Y, State Capitol
Juneau, Alaska 99811
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MEMORANDUM July 16, 1980

TO: Representative Patrick O'Connell

FROM: Anne DeVries
Issues Analyst

RE: Contract Bonding
Research Request No. 147 (Additional Material)

I have enclosed three excerpts from a report on the use of surety bonds in federal construction prepared by the General Accounting Office and submitted to the U.S. Congress. This report concluded that the government should not eliminate bonding and become its own self insurer. In addition, the report found problems in the ability of the SBA program to meet its objective of providing a transitional program for a marginal contractor.

One problem facing the SBA which I did not address was the involvement of organized crime in the specialty surety business. Recently, NBC Nightly News examined abuse of the SBA program in Chicago, where it is believed that fraudulent claims are being submitted by sureties fronting for organized crime. I do not know much about this beyond the NBC news story. However, if the State does consider a SBA-like program, this potential type of abuse may need to be examined more closely.

AHD/bf
Enclosure

EXHIBIT 1

States Licensing General Contractors

States	License Contractors	License Subcontractor	Dollar Limit	Bond Requirements
1. Alabama	Yes	No	$20,000	No
2. Alaska	Yes	No	1,000	$2,000 Surety
3. Arizona	Yes	No	NA	1,000 to 15,000
4. Arkansas	Yes	Yes	20,000	No
5. California	Yes	Yes	100	2,500
6. Florida	Yes	No	NA	No
7. Hawaii	Yes	No	NA	No
8. Louisiana	Yes	No	30,000	bond(1)
9. Maryland	Yes	No	5,000	amount-NA
10. Michigan	Yes	No	200	No
11. Mississippi	Yes	Yes	10,000	No
12. Montana	Yes	No	15,000	No
13. Nevada	Yes	Yes	NA	amount-NA
14. New Mexico	Yes	No	NA	No
15. North Carolina	Yes	No	30,000	No
16. North Dakota	Yes	Yes	500	No
17. South Carolina	Yes	No	30,000	No
18. Tennessee	Yes	Yes(2)	50,000	No
19. Utah	Yes	Yes	NA	bond(3)
20. Virginia	Yes	Yes	30,000	No
21. Wasnington	Yes	No	250	1,000 to 2,000

States Licensing Specialty Contractors

States	Type of License	Bonding Requirements
22. Idaho	Public Works Contractors	No
23. New Jersey	Electrical Contractors	No
24. Oregon	Residential Building Contractors	($3,000 bond requir
25. Wyoming	Electrical Contractors	No
26. Delaware	Registers Contractors for revenue only	No
27. Kansas	Nonresident Contractors	$1,000 bond require
28. Nebraska	Nonresident Contractors	$1,000 bond require

(1) Surety Bonds required for taxes on nonresident contractors.
(2) License only subcontractors who perform heating and ventilating, air conditioning, electrical, and plumbing work where the contract cost exceeds $50,000.
(3) 50 percent performance bond for public works contract.

amount NA-dollar amount not available.

Source: State of Tennessee Program Evaluation

REPORT TO THE CONGRESS

Use Of Surety Bonds In Federal Construction Should Be Improved

Multiagency

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

LCD-74-319

JAN. 17, 1975

ELIMINATING CURRENT BONDING SYSTEM DOES NOT APPEAR WARRANTED

We evaluated (1) the effectiveness of the current bonding system and (2) the economic and administrative feasibility of eliminating bonds and having the Government become a self-insurer.

In general, surety bonds and the surety companies provide

1. Financial protection to Government agencies against losses resulting from defaults.

2. Financial recourse for subcontractors, suppliers, and laborers.

3. Financial and technical aid for contractors.

The lack of cost data and the lack of Federal experience, particularly with respect to the latter two functions, prevented us from reducing the issue of self-insurance to a strictly quantitative determination. The monetary value of the individual services provided by sureties could not be isolated. Because the Federal agencies have had no experienc in providing these services, they could not state what the cost would be if the Government assumed such services.

In the absence of comparable quantitative data, we could not develop measurable evidence supporting either elimination or retention of the current bonding system. The major participants in the system--Federal construction agencies, contractors, subcontractors, suppliers, etc.--generally voiced opinions that surety bonds were needed and that the current system was effective and should be continued.

As discussed below, Federal construction agencies do not, at this time, have the ability to duplicate some of the services provided by sureties. Particular factors arguing against the Government's becoming a self-insurer are the lack of legal means, administrative machinery, and in-house expertise for handling claims of subcontractors, suppliers,

in trouble. Most Federal agencies surety bond [illegible] they could develop the necessary capabilities, it would probably prove costly to the Government.

Although we do not recommend eliminating the current bonding system, we feel that the Government is not benefiting as much as it could from surety bonds. Chapter 5 discusses those areas where the Federal construction agencies can improve their participation in the system.

CLAIMS OF SUBCONTRACTORS, SUPPLIERS, AND LABORERS

The basic purpose of the Miller Act is to provide a means of recourse for subcontractors, suppliers, and laborers on Federal construction projects. Payment bonds provide the means by which subcontractors, suppliers, and laborers can submit claims against contractors, even in the absence of defaults.

We examined selected project files at 9 Federal construction agencies, including files relating to 75 defaulted contracts. For 17 of the defaults, we examined the project files at both the Federal agency and the cognizant surety company. In many instances, subcontractors, suppliers, or laborers submitted claims or voiced complaints directly to the Federal agencies. Because these projects were bonded, the Federal agencies simply referred the complaints to the appropriate surety company. The fact that sureties handled the claims removed potentially major legal and administrative problems from the Federal construction agencies.

The surety industry has said that it does not keep overall statistics on the amount of claims submitted and paid on Federal construction projects. To ascertain the prevalence of claims, we reviewed selected surety companies. Presented below are examples of the situations we found.

Example 1

On a $36,000 Navy contract, a subcontractor submitted a claim for $29,000 to the surety company, citing nonpayment by the contractor. The surety maintains that,

as a result of paying the claim, it incurred a loss of $10,130. The surety also noted that its attempts to recover its loss from the contractor had so far proved unsuccessful.

Example 2

The contractor got into difficulty simultaneously on three multimillion dollar Federal projects. The surety allowed the contractor to complete all three projects and funded settlements with subcontractors and material suppliers. The surety cited payments on such claims of over $540,000, plus incurred expenses of over $20,000 and said that, so far, it had recovered only about $85,000 from the contractor.

However, in other instances the sureties contested subcontractors' and suppliers' claims. It is apparent that the sureties do not automatically pay all claims submitted under payment bonds. Rather, the sureties make certain determinations regarding the validity of the claims and the effect that payment or nonpayment will have on the sureties' financial exposure and on contract completion.

If bonds were eliminated, some other system for protecting subcontractors, suppliers, and laborers would have to be devised. Most Federal construction agencies believe that a workable system cannot be developed. The agencies feel that, even if a system could be developed, the administrative cost to the Government to operate the system likely would be high.

FINANCIAL AID TO CONTRACTORS

The surety keeps a bonded contractor's work program under surveillance to guard against the contractor overextending its total resources and thus subjecting the surety to potential financial losses. Should the contractor get into difficulty, the surety may be able to arrange for the loan of supervisory personnel, skilled technicians, or special equipment from other contractor clients of the surety. In addition, a surety sometimes provides or arranges for financial assistance to a contractor in trouble.

provide in-house technical assistance to a contractor. However, the agencies currently have no legal means, administrative machinery, or resources to provide financial aid to contractors in trouble.

As shown in the following examples, the surety companies can and do provide financial assistance to contractors.

Example 1

A contractor involved in a Federal dam project for the Corps of Engineers, Department of the Army, experienced a serious cash shortage that threatened its ability to continue operations. The surety elected to support the contractor and secured a $1 million line of credit for the contractor at a commercial bank. The surety guaranteed advances under the line of credit. As a result of the surety's aid, the contractor avoided default and completed the project.

Example 2

The contractor exhausted its capital at the time it was involved with nine bonded projects, including eight Federal jobs. The surety provided the contractor with enough capital to pay construction costs and to satisfy outstanding bonded job obligations. Surety payments on the Federal jobs totaled $138,500, plus legal and other expenses of over $5,000. The surety eventually was reimbursed.

It was evident from our study that the decision to provide financial aid to contractors was generally based strictly on sureties' concern for minimizing potential losses. If the surety determined that immediate financial aid would be less costly than the loss from default, the aid was provided. However, if the surety felt that it would be potentially less costly to take over the contract, the contractor was allowed to default.

DEFAULTS ON FEDERAL CONSTRUCTION

From the nine Federal agencies reviewed, we tried to obtain detailed data on the default history for a 10-year

period and the relationship of defaults to total construction activities. Only one of the nine agencies was able to provide complete information.

An analysis of the limited information available indicates that (1) most agencies experienced very few defaults and (2) the value of the defaulted contracts represented a very small portion of the total value of all construction contracts. For example, for the period 1963-72, AEC, NASA, and HEW were able to identify only five, two, and six defaults, respectively.

The Corps of Engineers was the only agency able to provide complete data comparing defaults to total construction activities. For the 10-year period, the Corps had 73 defaulted contracts having a total contract award value of about $30 million. During the period, the Corps awarded about 20,000 contracts valued at about $11.7 billion. The number of defaulted contracts represented less than one-half of 1 percent of total contract awards. On the basis of the total value of all contract awards, the value of the defaulted contracts was also less than one-half of 1 percent.

Generally, the cost of performance and payment bonds represents about one-half of 1 percent to three-quarters of 1 percent of the total contract price. Accordingly, it appears that sureties' losses on the Corps' defaulted contracts were considerably less than the bond premiums earned from such contracts. Surety figures show that, for all Federal contracts, the direct losses incurred averaged 51 percent for the period 1959-70--total premiums of about $241 million versus direct losses of about $123 million.

In comparing these figures to the total premiums paid on direct Federal construction (about $24 million annually), it appears that the Government could self-insure against losses from defaults if Federal construction agencies could keep losses from defaults, including the administrative cost of handling defaults, below $24 million annually. The agencies could not determine what their administrative costs would be if they had to assume the responsibility for handling defaults.

The above approach does not consider:

1. The costs related to the other services provided by sureties, particularly paying claims and providing financial aid to contractors.

2. What the default ratio would be if surety bonds were eliminated.

If bonds were eliminated, these two issues would become particularly important. Unless some substitute method was devised to handle claims and provide contractors with financial aid, defaults would increase.

Other factors affect the ratio of losses to premiums earned. When a default occurs, sureties try to minimize their losses through various legal sanctions against the defaulting contractor, such as attachment and subsequent liquidation of the contractor's equipment and personal assets. If the Government became a self-insurer, it would have to take similar actions or face the prospect of higher loss ratios.

Most agencies expressed satisfaction with sureties' efforts on defaulted contracts. Our review of defaulted contracts at both the Federal agencies and the surety companies generally supported the agencies' observations. Sureties were usually prompt in attempting to reach agreements with the agencies regarding arrangements for completing the projects. Generally the sureties (1) cooperated with the agencies in completing the projects and (2) honored the agencies' claims for reimbursement of additional contract costs incurred in completing the projects. As discussed in chapter 5, we believe the agencies, besides being reimbursed for increased contract costs, should also be reimbursed for the administrative costs incurred in handling defaults.

CONCLUSIONS

Because of the unavailability of cost data and the Government's inexperience in providing certain surety-type services, we could not quantitatively determine:

1. The value of the services provided by sureties particularly the value of handling claims of s contractors, suppliers, and laborers and providing financial aid to contractors in trouble.

2. Whether it would be economically feasible for Federal construction agencies to assume these services and have the Government become a self-insurer.

Therefore we do not recommend eliminating the curren bonding system. Factors arguing against the Government's becoming a self-insurer are its lack of legal means, admi istrative machinery, and in-house expertise for handling claims and providing financial aid to contractors.

AGENCY COMMENTS AND OUR EVALUATION

The Federal construction agencies supported our conclusion that there was no basis for recommending elimination of the current bonding system. For example, the Department of Defense (DOD) stated that it strongly supporte our "conclusion that the present basic system of performan and payment bonds in construction should be retained."

The Office of Management and Budget expressed the opinion that we might review the issues in greater detail. On the basis of factors cited in this chapter, however, we do not believe that additional review effort would produce enough meaningful data to make a definitive decision on the Government's becoming a self-insurer.

CHAPTER 6

SBA BOND GUARANTEE PROGRAM

As part of our study, we examined SBA's bond guarantee program. The program's basic objectives are to (1) provide bonds for small and minority contractors who cannot obtain bonds in the open market and (2) increase the viability of these contractors so they can make the transition ("graduate") to the regular bonding system. We believe that the program would be more effective if SBA developed formal criteria for graduating participating contractors and established a monitoring system to insure that sureties are complying with such criteria.

PROGRAM OPERATION

The bond guarantee program, established pursuant to Public Law 91-609 (15 U.S.C. 694a-b), allows SBA to guarantee, for a fee, any surety company against up to 90 percent of its losses resulting from a small contractor's breach of the terms of a bid, performance, or payment bond. To qualify, a contractor must be a small business with annual sales under $750,000 and be able to show that a surety bond is required and could not be obtained on reasonable terms and conditions without an SBA guarantee. The guarantee is limited to surety bonds on contracts up to $500,000.

SBA stated that, as of May 20, 1974, it had guaranteed bonds on 15,093 contracts having a total value of about $1 billion. As of that date, 99 sureties were participating in the program.

To obtain a bond, a contractor applies to a bond broker of its choice. The contractor furnished the broker with the necessary financial data, work history, and other information. If the broker decides that the contractor may be bondable, he refers the application to surety companies he represents until he finds a surety willing to bond the contractor.

A surety company which is interested in the contractor's application decides whether to (1) bond the contractor without an SBA guarantee, (2) bond with an SBA guarantee, or (3) not bond under any circumstances. If the surety determines an SBA guarantee is necessary, it sends a letter with supporting data to the appropriate SBA regional office

requesting the guarantee. SBA makes its own underwriting review and, if it is favorable, completes the guarantee agreement and returns it to the surety company.

When the bond is issued, the contractor pays SBA two-tenths of 1 percent ($2 per $1,000) of the contract's face value. In the case of partial bonds (less than 100-percent bonds), the contractor pays SBA either two-tenths of 1 percent of the contract's face value or 20 percent of the total premium charged by the surety, whichever is less. The contractor must also pay the surety the total bond premium, 10 percent of which the surety pays to SBA as its fee for the guarantee.

Claims and defaults

SBA officials stated that losses resulting from defaulted contracts were 1.24 percent of total completed contracts backed by guarantees.

Initially, reserves to cover potential claims resulting from payment defaults were about $400,000, or 1 percent of the $40 million in bonds outstanding. SBA subsequently raised reserves to about 2 percent because of an increase in the number of claims.

Defaults and claims against SBA bond-guaranteed contractors are handled by the sureties. SBA gives each surety written authorization to deal with such problems in a manner which is routine for the company and conducive to mitigating losses and insuring satisfactory completion of the contract.

Sharing ratios and premiums

The SBA program is often referred to as the "90-10 program" because of the method used to distribute risk exposure to premiums earned. SBA guarantees 90 percent of the risk

premiums. Consequently, sureties participating in the program incur only a 10-percent risk for 90 percent of the bond premiums collected.

The authorizing legislation stated that SBA could guarantee up to 90 percent of the penal amount of the bond in return for a reasonable portion of the premiums collected from the contractors. The disparity in the relationship of risk to premiums resulted from the uncompromising position taken by the surety industry during negotiations. According to SBA officials, the surety industry dictated the terms under which it would participate in the program. One condition the industry insisted on was that SBA had to agree to accept 90 percent of any loss for no more than 10 percent of the premiums collected. SBA agreed, and the industry indicated a willingness to reassess the adequacy of SBA's 10-percent share after 2 years of experience.

In February 1974, SBA met with surety representatives to reassess the "90-10" ratio. No change resulted from the meeting.

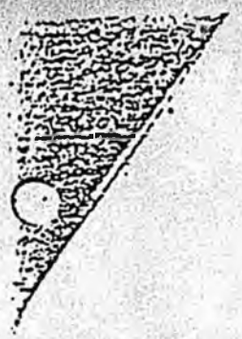
SBA's apparent lack of forcefulness in dealing with the industry was explained as being the result of the industry's take it or leave it proposition for SBA. SBA officials made the following observations.

—If SBA had not been willing to accept 90 percent of the risk, the industry would not have been willing to participate in the program.

—The surety's premium on the average guaranteed bond is not large and has to be shared with SBA and the broker.

—The 10-percent risk the surety faces makes it more responsible than it would be if it bore no risk whatsoever.

Sureties are allowed to charge higher premium rates for guaranteed bonds. Normally, bonds cost contractors $10 per $1,000 for contracts up to $100,000. However, for bonds issued under the SBA program, sureties were allowed to charge a rate up to $20 per $1,000. In March 1973, the rate



was changed to $15 per $1,000 for the first $5,000 and $10 per $1,000 thereafter.

NEED FOR INCREASED SBA PARTICIPATION IN PROGRAM OPERATIONS

The need for increased SBA guidance and program management is apparent. Specifically, SBA should provide formal guidelines and improved procedures for graduating guaranteed contractors.

According to SBA, the program is too new to have an adequate basis for graduation procedures, and the program operates under the assumption that a "surety will make every effort to graduate a contractor."

Because SBA does not have formal graduation procedures or a monitoring system, it does not know (1) the number of graduated contractors or (2) the number of contractors still in the program that should have been graduated. Therefore, SBA has not been able to determine the extent to which the program was accomplishing its objective.

CONCLUSIONS

It is apparent to us that, unless SBA develops adequate procedures for graduating contractors, its ability to insure that the program is accomplishing its objectives will be impaired. Accordingly, we believe SBA should develop formal criteria for graduating participating contractors into the regular bonding system and establish a monitoring system to insure that sureties are complying with such criteria.

RECOMMENDATION

We recommend that the Administrator of SBA direct that formal criteria be developed for graduating participating contractors into the regular bonding system and a monitoring system be established to insure that sureties are complying with such criteria.

AGENCY COMMENTS AND OUR EVALUATION

The Administrator, SBA, disagreed with our findings, conclusions, and recommendation regarding the bond guarantee program. With respect to our recommendation, he stated that SBA has established criteria by which its field offices will question the sureties on why a particular contractor is remaining in the program and not being graduated. SBA thinks, however, that the forces at work in the marketplace will

accomp- ... any use of funds that could be de-
vised.

After receiving its comments, we asked SBA to provide us with a copy of the established criteria. SBA officials stated that there was no written criteria, just an understanding among SBA's field offices to review a contractor's file when a surety applies for a guarantee.

The officials acknowledged that SBA has no systematic method for determining whether a contractor has, in fact, graduated. It should be recognized that "marketplace conditions" could produce results other than graduation, such as a contractor no longer being in business or maybe being involved in projects that do not require bonds.

We still believe the program would be more effective if our recommendation were implemented. Following are comments from those Federal construction agencies--GSA, Transportation (DOT), and NASA--that discussed the SBA section of the report.

GSA--"Since the recommendations directed primarily toward SBA would generate certain benefits for the procuring agencies participating in the small business programs, we also support those recommendations."

DOT--"We do not object to the recommendations concerning the Small Business Administration's involvement in the Surety Bond Guarantee Program."

NASA--"We believe the GAO findings to be accurate and their recommendations sound."

Our report was also reviewed by representatives from the Surety Association of America, the American Insurance Association, the Reinsurance Association of America, the National Association of Surety Bond Producers, and several surety companies. All the representatives stated that the SBA section of the report was an accurate description of the SBA program and how it is currently operating.

After carefully considering SBA's informative response, we still believe our report accurately reflects the current state of the bond guarantee program, a view supported by the Federal construction agencies and the surety industry. We believe that implementation of our recommendations will make the program more effective and its goals more readily attainable.

STATE OF ALASKA

POUCH V
JUNEAU, ALASKA 99811
(907) 465-3892

HOUSE LABOR AND COMMERCE COMMITTEE

To: House Labor and Commerce Committee

From: Walt Furnace, Chairman

Date: September 26, 1983

This interim the House Labor and Commerce Committee is specifically looking into the question of licensed and bonded contractors.

At the present time there are a multitude of contractors who are leading the public to believe that they are both licensed and bonded though neither is the case. Should these contractors produce inferior work, the consumer is often left with no recourse other than to repair the damage out of his own pocket.

Further, sometimes a licensed and bonded contractor will produce inferior work and the cost of his damage exceeds the bond posted. Again, this means that consumer often has no recourse but to pay for repairs out of his own pocket.

The intent of the hearings in Fairbanks, Ketchikan and Anchorage is to seek an answer to the following three questions:

1) Are there enough serious abuses of the law to suggest that the Legislature should demand stricter enforcement of the licensing and bonding sector?

2) Are there enough serious abuses to the consumer by licensed and bonded contractors to warrant the establishment of some testing and credentialling of those businesses who represent themselves to the public as licensed contractors?

3) Is the amount of bonding sufficient and, if not, is there another reasonable manner in which the consumer can be protected financially from inferior work by licensed contractors?

STATE OF ALASKA

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HOUSE LABOR AND COMMERCE COMMITTEE

To: All members of the House Labor and Commerce Committee

From: Representative Walt Furnace, Chairman

Date: September 21, 1983

RE: Licensed/Bonded Contractors

Enclosed please find a selection of materials you may find informative for the meetings on September 26 and October 3.

MEMORANDUM State of Alaska

TO. Connie Sipe
Chief, Consumer Protection
Department of Law-Anchorage

DATE: March 23, 1982

FILE NO:

TELEPHONE NO:

FROM: Deborah Feldman
Investigator
Consumer Protection-Anchorage

SUBJECT: Contractors

I examined approximately 97 consumer complaint files filed in the Anchorage Consumer Protection Office between January 1979 and February 1982 -- a little over 3 years worth of complaints. These contractor complaints do not involve any consumer complaints against plumbers, furnace repair people, or electricians. Also, complaints against developers, architects, designers, and real estate agents are not included, although in a number of cases consumers had home improvement or home construction related complaints against these kinds of professionals. A breakdown on the categories of complaints is as follows:

General Contractor/Home Builder	41
Landscape/Excavating	18
Home Improvement Installations (glass, fireplace, tile, flooring)	9
Insulation/Roofing	7
Drywall/Painting	6
Masons/Asphalting	4
Fencing Installation	4
Drilling	4
Carpenter	2
Other	1
Total	97

Below is a breakdown of contractor complaints by years:

1979	27
1980	32
1981	29
1982 (Jan/Feb)	8
Total	97

The figures available for 1982 reflect that 8 complaints have already been filed with the Consumer Protection Section. Projected over the course of the year the 1982 total could be 48 complaints, a 33% increase over the next highest year, 1980. This would seem to be a conservative projection, as there will be approximately 4,500 housing starts in Anchorage alone this year. With this increased building activity it is likely that there will be a substantial increase over the year.

A breakdown by area is as follows:

Anchorage	76
Outlying areas (Willow, Wasilla, Palmer)	8
Kenai area	8
Bush	4
Fairbanks	1
Total	97

The following is a list of dwelling unit starts in Anchorage for 1980 and 1981. Also listed is the projected number of starts for 1982.

Dwelling Unit Starts

1980	1,071
1981	2,601
1982 (projected)	4,000-4,500

The figures almost speak for themselves. The projected growth in dwelling unit starts for the Anchorage ara will be between 35% and 43%.

The impact of this increased activity upon the consumer is obvious. More contractors will be competing for this new business and our experience with the oil pipeline boom indicates that many of these new contractors will be "take the money and run" types.

Comments Regarding These Complaints:

Although it was difficult to do so, I attempted to evaluate the legitamacy of the consumer's complaint by reading through the entire file, including the business's response to the complaint. In approximately three cases out of the 97, consumers appeared to have perhaps been unreasonable in their complaints (e.g., demanding repairs past the warranty time, demanding changes in the contract after work had commenced). In one additional case, the business claimed that it sold the house as a private party and that our office had no jurisdiction over the repair complaint.

In approximately 90% of the remaining cases, the business either (a) did not respond to the consumer complaint; (b) had disappeared or absconded with money; (c) gave a partial correction or adjustment to the consumer; or (d) disputed the consumer's version of the facts. In these latter cases, our office usually ended up referring the consumer to a private attorney or small claims court because our office does not have the resources to assess in any depth evidence presented in an individual complaint. For example, businesses often disputed that there existed any corrective work for them to do or that the corrective work was so small in nature that it did not fall under any warranty or guaranty. Another problem is that verbal agreements were often made between the contractor and the consumer, eventually leading to many contract disputes over the terms of the agreement which could not be readily evaluated.

Because of the above-mentioned factors present in these disputes between consumers and contractors, our resolution rate on these disputes is very low -- approximately 10% consumers achieved a satisfactory settlement through our office. This is a much lower rate than our normal rate (40%) of resolution of consumer complaints through mediated settlement.

In addition to written complaints, our office receives a number of phone-in complaints against contractors. Our information officer takes these phone-in complaints but also generally refers consumers with contracting complaints to Ocupational Licensing and the Department of Labor. In many cases, the consumer calls us in the hopes that the Consumer

Protection Office can intervene legally on the consumer's behalf. Often when the consumer finds out this is not the case, he/she may file directly in court or go to Occupational Licensing or the Department of Labor without filing a written complaint with Consumer Protection. In fact, the more serious or legally urgent the contractor complaint, the more strongly we urge seeing a private attorney and then we often do not get a written consumer complint on those cases.

In reviewing our phone logs, our information officer estimates that at least 55-60 additional contractor complaints were received by the Consumer Protection Office in 1981. These complaints are not reflected in the previously discussed charts because written complaints were not formally processed in these phone-in cases. Total estimated contractor complaints (not including plumbers, electricians, etc.) for 1981 alone could be 87-92.

There is a high percentage of contracting businesses which shut down, enter bankruptcy, or simply disappear after a consumer complaint is filed, making any kind of resolution of a complaint pretty impossible.

Complaints About Quality of Contractor's Work
(1979-1982 sample from 97 total number of written complaints)

Major delays	12
*Deviation from Original Plan	6
*Extra Charge/Cost Overruns	5
*Defective Work/Major/ Structural	35
*Defective Work/Finish/ Cosmetic	22
*Defective Work/Code Violation	6
*Defective Work/Operational	11
*Incomplete Work/Major	9
*Incomplete Work/Finish/ Cosmetic	26
*Incomplete Work/Operational	4
*Clean-Up	4
Total	140

Note: Categories which reflect complaints of a more major or serious nature have an (*) asterisk. Total number of serious complaints from these categories is 82 or 59% of all 140 allegations. (The figure is conservative since the other categories also contain complaints which are more serious in nature but are not counted in the 59% figure as time has not permitted more detailed analysis to be made of these complaint categories.) Also, below are listed some other serious problems consumers encounted with contractors as far as method of doing business which are not accounted for in the 59% figure.

Misrepresentations Connected with Contractor Complaints
(1979-1982 from 97 total written complaints)

Misleading or False Advertising	20	(approximately)
Misrepresentation Qualifications, Licensing, etc.	9	
Promised Corrective Work Not Done	20	
Misrepresented Terms of Agreement	13	
Misrepresented Money Would Be Refunded	3	
Not properly licensed.	?	
Total	65	

ALASKA JOURNAL OF COMMERCE & PACIFIC RIM REPORTER

Crackdown sought on no-license contractors

By PAUL LAIRD
AJC Editor

Earl Carlyle is a painting contractor who's mad as hell and isn't going to take any more.

A licensed painting contractor who's mad as hell nd isn't going to take any more.

The owner of Earl's Custom Home Painting in Anchorage, this uncaped crusader is conducting a one-man campaign to mobilize licensed specialty contractors throughout Alaska and force the state to crack down on unlicensed contractors in all trades.

"I don't know about doing research," he said. "I do know about raising a lot of hell. I'm tired of living in a trailer and not being able to prosper even after seven years in business."

What he lacks in research expertise he compensates for in ability to match names in a state directory of licensed contractors against names of contractors listed in the Yellow Pages of the Greater Anchorage telephone directory.

State law prohibits unlicensed contractors from advertising. Nonetheless, Carlyle says he's found nearly 500 contractors without licenses advertised in the phone book.

State Rep. Walt Furnace, R-Anchorage and chairman of the House Labor & Commerce Committee, said many contractors don't bother to secure state licenses because the process is time-consuming.

"The process isn't cumbersome, but it is time-consuming," he said. "We all have a thing about filling out forms."

While requirements for contractors' licenses aren't that stringent, they do require somewhat of a commitment from the applicants. To secure licenses, contractors must have bonding, insurance and workers' compensation programs.

Carlyle said that by avoiding those requirements, unlicensed contractors are able to underprice those with licenses, and they also sidestep accountability for their work.

He said his investigation of the problem through classified advertising in daily newspapers and bidding fo rms published by general contractors for their projects leads him to believe the 500 unlicensed contractors in the Yellow Pages are only the tip of the iceberg.

During the suimmer, there could be as many as 2,000 unlicensed contractors operating in the Municipality of Anchorage, he said.

Furnace said most unlicensed contractors in the Anchorage area seem to be subcontractors, It's licensed companies operating in a subcontractor capacity that seem to be injured most.

Carlyle said some licensed contractors in Alaska have been forced out of business by price undercutting from unlicensed competition, both from within Alaska and Outside. Others have been forced to live indefinitely from one job to the next.

"Fly by nighters" who "guarantee their work right up to the time when the plane leaves" cost his business about $500,000 in jobs during his first five years of painting contracting, he said. Now he's beginning to live off referrals.

"These fly by nighters bring their out-of-state prices with them, and a licensed contractor can't compete," he said. "They don't keep books, they don't pay taxes and they don't incur the expenses of doing business here during the winter. "They just come in the spring and split in the fall when it gets cold. They don't have to eat their mistakes; the consumer does."

Earlier this year he engineered a write-in campaign of more than 1,000 of the state's specialty contractors to the governor, key legislators and other state officials. Goal of the campaign was to build awareness of the problem and to prompt stricter enforcement of state law barring unlicensed contractors from working in Alaska.

One legislator reported receiving more than 1,000 letters from specialty contractors throughout Alaska.

"That must mean there are 1,000 specialty contractors who are as mad as I am," Carlyle said. "I think we're starting to get some attention now."

Although the Anchorage painting contractor said he's contemplating another mailing blitz, the first one apparently found its mark.

Furnace said his committee is studying the problems of local hire and unlicensed contractors before the next legislative session begins in January, and public hearings will be scheduled for Anchorage, Fairbanks, Ketchikan or Juneau and possibly Bethel or Kotzebue sometime this month.

"At this point we don't know what the overall effect of unlicensed contractors operating in the state is, and we don't know how severe the income loss is to licensed contractors," Furnace said. "That's what we hope to determine from testimony at these hearings."

Carlyle blames the unlicensed contractor problem on spotty enforcement by the state, and Furnace agrees. The Anchorage legislator said the Department of Commerce & Economic Development division responsible for enforcement—the Division of Occupational Licensing—has been stymied by manpower shortages.

"There are too few people responsible for keeping track of too many things in the division," Furnace said. He added he believes the problem is not a lack of money in the department's budget, but rather questionable priorities of how the money is spent.

"There's never been a shortage of money (in the department)," he said. "The shortages in enforcement manpower have been the result of the way the money is allocated."

A number of approaches to the problem are being considered, and notification of this month's hearings will be mailed to nearly 2,000 specialty contractors statewide to generate responses to existing proposals and other ideas.

The Anchorage painting contractor said he expects widespread support for the move to push for stricter enforcement, but he also anticipates resistance from some general contractors who capitalize on the availability of cheaper unlicensed subcontractors.

He said he's encountered a handful of subcontractors afraid to become active in the involvement for fear general contractors will refuse them work.

Established contractors' organizations won't resist the move, he said, but some individual general contractors who use unlicensed subcontractors will lobby against it.

"We're going to need strong organization before the legislative session starts if we want to accomplish anything," he said.

Though shoddy workmanship and lack of accountability are major problems with unlicensed contractors, Carlyle said the state should not instate written examinations to assure competency.

"Some real artists and craftsmen couldn't pass a written test, but they could certainly pass a test on the job," he said.

Carlyle received an assurance from a special assistant to Gov. Bill Sheffield late in the spring that the Division of Occupational Licensing has been working with the Department of Law to develop a citation program to enforce regulations restricting unlicensed contractors.

The special assistant wrote Carlyle that some names he supplied to the division indeed are practicing without licenses, and those violators were sent warning letters.

"The list of names will be monitored for compliance and are potentially the first to be cited when the program begins if they are not licensed," the special assistant wrote.

Furnace said he believes many of the violators simply don't know they're not complying with state regulations, and he hopes to avoid an enforcement approach that will be punitive.

"Some contractors think all they need is a business license," he said. "It's one of the problems of the easy entrance and easy exit in business in Alaska."

He added he hopes the problem can be addressed at least partially without adding to state statutes.

"The main thing is that we have to prevent unlicensed people from posing as experts by advertising," he said.

A possible solution, the Anchorage legislator said, is soliciting voluntary cooperation from newspapers of general circulation and from the people who compile the Yellow Pages.

By screening unlicensed contractors from advertising, those sources could prevent unlicensed contractors from posing as experts, Furnace said. One Anchorage daily already operates under that policy, he added, but the other doesn't

"We'd like not to have to put that kind of thing into statute form, but we do need the help of the private sector in attacking the problem," Furnace said.

He added he doesn't believe the licensing process on the books now is in need of revamping.

An aide to Furnace said the following list of solutions is being studied, but some are believed unworkable. The legislator's office is soliciting reactions to and suggestions about these proposals:

- Require all contractors to include contracting license numbers in all advertising.
- Require contractors to place signs on both sides of their vehicles stating company names and contracting license numbers.
- Increase bonds for specialty contractors to $5,000 and for general contractors to $15,000.
- Give enforcement inspectors authority to check identification and issue citations.
- Establish a state division for policing contracting laws.
- Mandate that enforcement officers to police newspapers, Yellow Pages, television and radio for violators.
- Adopt legislation requiring telephone utilities to disconnect service for unlicensed contractors.
- Impose stiffer penalties for violators.
- Prohibit state agencies from contracting with unlicensed contractors and licensed contractors who subcontract to unlicensed subcontractors. Prohibit projects using unlicensed contractors or subcontractors from taking advantage of state financing or refinancing for one year.
- Have a computerized list of contractors available on demand that would include the kind of contractor, license number, company name and address.

Proposals for ensuring compliance with local hire laws include requiring the submission and monitoring of a statement of the percent of work force to be hired locally when state funds are involved, requiring quarterly filings of compliance statements and the use of spot audits and penalties.

Offered: 4/3/84
Referred: Finance

Original sponsor: Furnace

IN THE HOUSE

BY THE LABOR AND COMMERCE COMMITTEE

CS FOR HOUSE BILL NO. 610 (L&C)

IN THE LEGISLATURE OF THE STATE OF ALASKA

THIRTEENTH LEGISLATURE - SECOND SESSION

A BILL

For an Act entitled: "An Act relating to construction contractors; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 08.18.011 is amended by adding a new subsection to read:

(b) A general contractor may not allow a person required to be registered under this chapter to begin work for the general contractor as a specialty contractor unless the person is registered under this chapter.

* Sec. 2. AS 08.18.031 is amended by adding a new subsection to read:

(b) The commissioner may not issue a certificate of registration or renew the registration of an applicant whose registration has been revoked or suspended or against whom a fine has been imposed under this chapter until the period of revocation or suspension has expired and any fine has been paid.

* Sec. 3. AS 08.18.051 is amended to read:

Sec. 08.18.051. IDENTIFICATION REQUIREMENTS [REGISTERED NAME]. (a) Except as provided otherwise by [STATE] law, a [NO] person who has registered under one name as required by this chapter may not act in the capacity of a contractor under any other name unless that name also is registered.

(b) All advertising, contracts, correspondence, cards, signs, posters, papers and documents prepared by a contractor for the contracting business shall [WHICH] show the contractor's name, mailing

[AND] address, and address of the contractor's principal place of business. Advertising and contracts shall also include the contractor's registration number [SHALL SHOW THE NAME AND ADDRESS AS REGISTERED UNDER THIS CHAPTER].

(c) Individual contractors and partners, associates, agents, salesmen, solicitors, officers and employees of contractors shall use their true names and addresses at all times while acting in the capacity of a contractor or performing related activities.

* Sec. 4. AS 08.18.071(b) is amended to read:

(b) If the applicant is a general contractor the amount of the bond shall be $10,000 [$5,000]; if the applicant is a specialty contractor the amount of the bond shall be $5,000 [$2,000]. In lieu of the surety bond the applicant may file with the commissioner a cash deposit or other negotiable security acceptable to the commissioner [OF COMMERCE] in the amount specified for bonds.

* Sec. 5. AS 08.18 is amended by adding a new section to Article 3 to read:

Sec. 08.18.120. INVESTIGATIONS AND ISSUANCE OF CITATIONS. (a) The department shall provide investigative services to enforce the provisions of this chapter. A peace officer or an employee of the department designated by the commissioner to conduct investigations under this subsection may issue a citation for a violation of this chapter. The provisions of AS 12.25.200 - 12.25.230 apply to the issuance of a citation under this subsection. Each day a violation continues after a citation for the violation has been issued constitutes a separate violation.

(b) The supreme court shall establish a schedule of bail amounts for violations of this chapter, but in no event may the bail amount exceed the maximum fine that may be imposed for the violation. The

bail amount for a violation shall appear on the citation.

(c) A person cited for a violation under this section may, within 15 days after the date of the citation, mail or personally deliver to the clerk of the court in which the citation is filed

(1) the amount of bail indicated on the citation for that violation; and

(2) a copy of the citation indicating that the right to an appearance is waived, a plea of no contest is entered, and the bail is forfeited.

(d) When bail has been forfeited under (c) of this section, a judgment of conviction shall be entered. Forfeiture of bail is a complete satisfaction for the violation. The clerk of the court accepting the bail shall provide the violator with a receipt stating that fact.

(e) If the person cited fails to pay the bail amount established under (b) of this section or to appear in court as required, the citation is considered a summons for a misdemeanor.

* Sec. 6. AS 08.18.121(f) is amended to read:

(f) If the commissioner of labor <u>or the commissioner of commerce and economic development</u> determines that a person is acting as a contractor in violation of this chapter, the commissioner shall give written notice prohibiting further action by the person as a contractor. The prohibition continues until the person has submitted evidence acceptable to the commissioner [OF LABOR] showing that the violation has been corrected.

* Sec. 7. AS 08.18.121(g) is amended to read:

(g) A person affected by an order issued under this chapter may seek equitable relief preventing the commissioner of labor <u>or the commissioner of commerce and economic development</u> from enforcing the

order.

* Sec. 8. AS 08.18.131 is amended to read:

Sec. 08.18.131. INJUNCTION. In an action instituted in the superior court by the commissioner of commerce and economic development or the commissioner of labor [OR THE COMMISSIONER'S REPRESENTATIVE], a person acting in the capacity of a contractor in violation of this chapter may be enjoined from doing so. In addition to other relief, a civil penalty not to exceed $250 may be imposed for each violation. Each day that an unlawful act continues constitutes a separate violation.

* Sec. 9. AS 08.18.141 is amended to read:

Sec. 08.18.141. MISDEMEANOR. A person acting in the capacity of a contractor in violation of this chapter is guilty of a class A misdemeanor.

* Sec. 10. AS 08.18 is amended by adding a new section to read:

Sec. 08.18.163. PROHIBITION ON STATE LOANS. A state agency, corporation, or authority may not lend money for construction of a project or building that is constructed in violation of AS 08.18.011. The state agency, corporation, or authority shall make reasonable efforts to determine whether construction is proceeding in accordance with AS 08.18.011 before releasing money under a construction loan.

* Sec. 11. AS 08.18.171 is amended by adding a new paragraph to read:

(4) "department" means the Department of Commerce and Economic Development.

* Sec. 12. Sections 1, 2 and 4 - 11 of this Act take effect July 1, 1984.

* Sec. 13. Section 3 of this Act takes effect July 1, 1985.

Introduced: 2/13/84
Referred: Labor & Commerce and Finance

IN THE HOUSE BY FURNACE

HOUSE BILL NO. 610

IN THE LEGISLATURE OF THE STATE OF ALASKA

THIRTEENTH LEGISLATURE - SECOND SESSION

A BILL

For an Act entitled: "An Act relating to construction contractors, establishing the Board of Builders; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 08.01.010 is amended by adding a new paragraph to read:

(24) Board of Builders (AS 08.18.120).

* Sec. 2. AS 08.01.050(a)(19) is amended to read:

(19) provide investigative services to the boards established under AS 08.04, AS 08.18, AS 08.20, AS 08.36, AS 08.64, AS 08.68, AS 08.70, AS 08.71, AS 08.72, AS 08.80, AS 08.84, and AS 08.86, for the purpose of assisting those boards in matters of professional discipline and in responding to consumer complaints.

* Sec. 3. AS 08.01.070 is amended by adding a new subsection to read:

(b) (a)(3), (5), (6), and (8) of this section do not apply to the Board of Builders established under AS 08.18.120.

* Sec. 4. AS 08.01.087(b) is amended to read:

(b) If it appears to the commissioner that a person has engaged in or is about to engage in an act or practice in violation of a provision of this chapter or a regulation adopted under it, or any of the laws pertaining to or regulations adopted by the boards listed in AS 08.01.010, the commissioner may, if the commissioner considers it in the public interest, and after notification to all board members by telephone or telegraph of a proposed order or action unless a majority of the members of the board object within 10 days,

(1) issue an order directing the person to stop the act or practice; however, reasonable notice of and an opportunity for a hearing must first be given to the person, except that the commissioner may issue a temporary order before a hearing is held; a temporary order remains in effect until a final order affirming, modifying, or reversing the temporary order is issued or until 15 days after the person receives the notice and has not requested a hearing by that time; a temporary order becomes final if the person to whom the notice is addressed does not request a hearing within 15 days after receiving the notice; the commissioner or the commissioner's designee shall be the hearing officer at the hearing and shall issue a final order within 10 days after the hearing;

(2) bring an action in the superior court to enjoin the acts or practices and to enforce compliance with this chapter, a regulation adopted under it, or an order issued under it, or any of the laws pertaining to or regulations adopted by the boards listed in AS 08.01.010;

(3) examine or have examined the books and records of a [ANY] person whose business activities require licensure under AS 08.18 or by a board listed in AS 08.01.010 and [HE] may require that person to pay the reasonable costs of the examination; and

(4) issue subpoenas for the attendance of witnesses, and the production of books, records and other documents.

* Sec. 5. AS 08.01.110(4) is amended to read:

(4) "license" means any license, certificate, permit, or registration or similar evidence of authority issued under AS 08.18 or by one of the boards listed in AS 08.01.010;

* Sec. 6. AS 08.01.110(6) is amended to read:

(6) "occupation" means any of the trades or professions for

which licensure is required under AS 08.18 or by one of the boards listed in AS 08.01.010.

* Sec. 7. AS 08.02.020 is amended to read:

Sec. 08.02.020. LIMITATION OF LIABILITY FOR MEMBERS OF [LICENSING] BOARDS. A person is not liable for damages or other relief in an action by reason of the person's performance of a duty, function, or activity as a member of a [LICENSING] board listed in AS 08.01.010 or by reason of a recommendation or action of the board when the person acts in the reasonable belief that the action or recommendation is warranted by facts known to the person or to the board after reasonable efforts to ascertain the facts upon which the action or recommendation is made.

* Sec. 8. AS 08.03.010(c) is amended by adding a new paragraph to read:

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* Sec. 9. AS 08.18.011 is amended by adding a new subsection to read:

(b) It is unlawful for a general contractor to accept the bid of or hire a person to work as a specialty contractor unless the person is registered under this chapter.

* Sec. 10. AS 08.18.031 is amended by adding a new subsection to read:

(b) The commissioner may not issue a certificate of registration or renew the registration of an applicant whose registration has been revoked or suspended or against whom a civil penalty has been imposed by the board until the period of revocation or suspension has expired and any penalty has been paid.

* Sec. 11. AS 08.18.051 is amended to read:

Sec. 08.18.051. IDENTIFICATION REQUIREMENTS [REGISTERED NAME]. (a) Except as provided otherwise by [STATE] law, no person who has registered under one name as required by this chapter may act in the capacity of a contractor under any other name unless that name also is