



Leaving Performance Bonds at the Door for Improved IT Procurement

NASCIO IT Procurement
Modernization Series: Part II

August 2012

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In partnership with TechAmerica* and NASPO**, the NASCIO IT Procurement Modernization Committee continues to focus on state IT procurement reforms and highlighting best practices at the state level. This brief is the second in a series of recommendations set forth by this collaborative.

Performance Bonds - Friend or Foe?

Though once easily attainable, the surety market has significantly changed because of a wave of factors external to the IT industry, mainly the high-visibility bankruptcies of the early 2000s. While there are numerous types of bonds such as bid bonds, payment bonds, bail bonds, and fidelity bonds, this brief is focusing exclusively on performance bonds in state IT procurement. The types and amounts of performance bonds have drastically been reduced and, in some instances, bond companies have begun to require companies to partially or fully collateralize performance bonds with bank letters of credit, substantially increasing the overall bonding cost.¹

Not all states are required to have performance bonds for contractors, but for those that do it has led to significantly limited competition because smaller companies don't have the capital to qualify for high dollar performance bonds, smaller companies suffer from limited bonding ability by the surety market, and bond collateralization can create an adverse impact for smaller businesses. In addition, the cost of obtaining any bond has exponentially rose - *in some instances 40 times higher than the cost of an existing bond obtained prior to the corporate scandal period.*²

Intent of Performance Bonds

To understand why performance bonds have been used, it is important to consider the intent of the proceeds of the bond. Generally if a bond was called it would be used to pay for the customer expenses related to procurement of a new solution in the event that the contractor failed to perform or was no longer capable of performing.³ Essentially a performance bond is a written guaranty from a third party guarantor (surety or bonding company) submitted to an obligee (state government) by a principal (contractor) upon

winning the bid. A performance bond ensures payment of a sum (not exceeding a stated maximum) of money in the event that the contractor fails in the full performance of the contract.

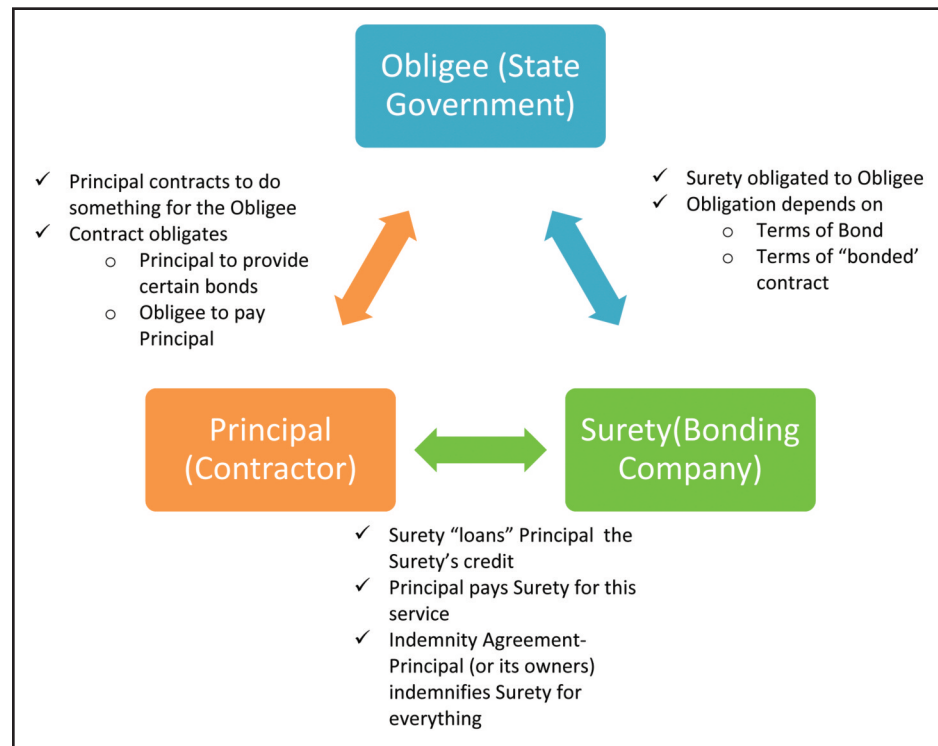
Performance Bonds are Not Insurance

Unlike a fidelity bond, a performance bond is not an insurance policy and (if cashed by the principal) the payment amount is recovered by the guarantor from the contractor.⁴ Performance bonds are not meant to provide third party coverage for damages suffered by a state as a result of the contractor's inability to perform. Hence, a performance bond is not an indemnity instrument and recovery of damages can be achieved through insurance, warranties, or other contractual and legal remedies.⁵

Who's Who?

Bonds typically have three parties that share a legally binding relationship. The surety is the bonding company that is legally responsible for another's obligation. The principal is the contractor that has requested the services of surety. Last, but not least, the obligee would represent the government in the state procurement process. This relationship has been modeled in Figure 1.

Figure 1- Performance Bond Relationships



Balancing the Scales of Risk vs. Reward

Vendors considering competing for state IT contracts may be chased away by high bond percentage requirements. This can lead to reduced competition and actually push out small businesses that would otherwise participate. States can use service level agreements, warranties, insurance, holdbacks, liquidated damages, penalties, and other contractual remedies to ensure contractors meet expectations, or as a remedy to failing projects. Overall, performance bonds lack effectiveness because they are time consuming, ex-

pensive to collect, and may not be collected in some instances. Several states, and the Federal government, have already abandoned the use of performance bonds because of the low value they provide to IT contracts. Figure 2 provides a list of the pros and cons of performance bonds when states use contractors for IT solutions.⁶

The North Dakota Experience

The State of North Dakota has experience with performance bonds, but it has been a dilemma when building new systems. When the North Dakota Public Employees Retirement System (NDPERS) contracted with a company to build a new pension and insurance system, a 20% performance bond was requested and the State quickly learned a few hard lessons from this experience.

Below are a few of the takeaways that states should consider⁷:

- With construction bonds, surety companies often know how to evaluate project failures.
- In software development projects, the surety companies have a difficult time evaluating the work and projects that are not functional may need to completely start over. In fact, based upon North Dakota's experience in other projects, it is cheaper to start from scratch than to try to fix a partially written code that failed.
- Nearly 90% of surety companies that the vendor contracted with would not take a software performance bond.
 - The surety companies that did take software bonds wanted 100% collateral. The cost of tying up that much operating capital was directly passed back to the client, NDPERS.

Figure 2- Pros & Cons of Performance Bonds

Performance Bond Cons:

- ✓ Increased contract prices
- ✓ Increased cost of claims
- ✓ Defenses for payment increase
- ✓ Principal still maintains control through surety
- ✓ Liability limited to penal sum
- ✓ Surety liable only for material breach
- ✓ Surety's liability co-extensive with principals
- ✓ State's material default excuses surety
- ✓ Need an expert in bond litigation
- ✓ Surety can allow principal to finish, or hire another contractor

Performance Bond Pros:

- ✓ Surety will review contractors history
- ✓ Surety is obligated to pay if necessary
- ✓ Bond continues until contract resolution

The NDPERS example only helps to highlight the need for changing the requirements for performance bonds in states and how the costs can be pushed back to the states. It is costly to require performance bonds that, in many instances, don't provide an effective remedy for failing projects.

The "Eureka" State

The State of California is often referred to as the "Eureka" state for good reason and in 2007 they found agreement on adjusting the exceptionally high 50% requirement for performance bonds. Prior to enactment of the unanimously passed bill in 2007, California suffered from procurement delays, vendor drop-out, and increasing costs to vendors. The increasing overall costs to vendors were then passed on to tax-payers because of a requirement that already had multiple contractual protections.

The previous California statute mandated that all contracts with the State for IT goods or services that contained “progress payments” were required to have in place a performance bond in the amount of 50% of the total contract value. This requirement was applied regardless of whether a bond of that size was necessary to protect the State from risk and regardless of whether other risk protection options would better suit the State’s needs. Efforts are underway to ensure that the State can continue to benefit from greater competition and the resulting cost-savings when it comes to IT procurement, all while maintaining the flexibility to best determine how to protect itself from risk. While state statutes vary, the “Eureka” moment for procurement modernization is realizing that using performance bonds in conjunction with technology projects can create unforeseen obstacles.

Suitable Use and the Fork in the Road for IT Services

There has been an increased commoditization of IT goods and services and the utilization by federal, state and local government agencies of commercial-off-the-shelf hardware and software packages has also been amplified. These IT services tend to have minimal client-specific modifications and very few IT contracts in the public sector are for items not suitable for sale to others in the ordinary course of the contractor’s business.⁸ While vendors may invest substantial resources to IT projects as they progress, there aren’t necessarily any payments until the project is completed and the state has approved the outcome.

In other instances, such as construction contracts, it is quite common for the contractor to require some upfront payment to cover materials needed to perform the services. Payments and progress payments would occur as the project progressed and as the contractor required more materials. For construction, the state would want to protect its upfront investment to avoid the risk of no return for the payment.

On the other hand, in IT deliverables-based contracts, the state would pay nothing, and in fact the contractor absorbs much of the initial capital required until the deliverable has been delivered or the milestone has been reached. The deliverables must of course be accepted by the state and the risk remains relatively low to the state. Any remaining risk the state may have can be addressed with other means such as contract provisions, hold-backs, and other remedies.⁹ Essentially, businesses that are investing substantial capital towards contracts may have added costs incurred and thus may not participate in the competition pool.

Hand-in-Hand Collaboration and Performance Monitoring

While some states may act in a risk-adverse manner and require contracts to be issued only for proven solutions, it is rare that states would request true turnkey IT solutions that don’t involve collaboration between the contractor and state personnel on finding the full solution. The more common scenario is that contractors and state personnel are working hand-in-hand to design and finalize solutions with the development and testing taking place predominantly at a state facility with intense involvement by state personnel. For instances like this, the state can continually monitor the contractor’s progress in successful solution completion and can take swift action in the event that its performance is non-conforming.¹⁰

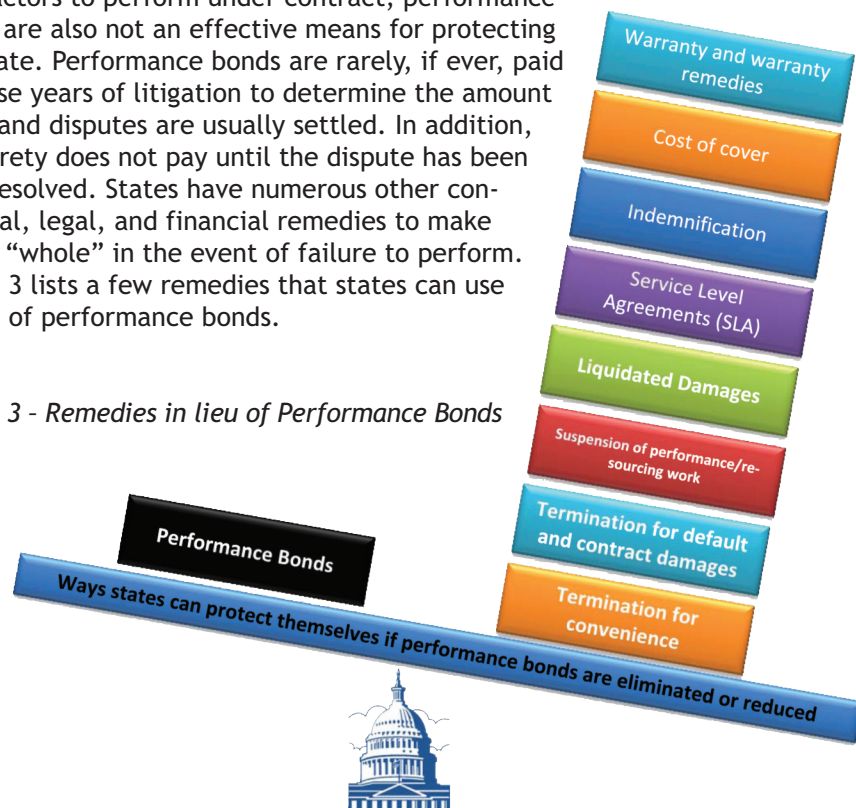
What disciplines can help states create stronger collaboration and meet skill requirements?

- **Independent Verification & Validations (IV&V)**¹¹ - The primary objective of an IV&V engagement is to provide an objective assessment of products and processes throughout the project lifecycle. In addition, IV&V will facilitate early detection and correction of errors, enhance management insight into risks and ensure compliance with project performance, schedule, and budget requirements. IV&V can help provide assurance of project success in an enterprise and is accomplished in two ways:
 - First, by communicating and educating the project management team on industry best practices for specific undertakings.
 - Secondly, by providing an escalation path for issues and inhibitors of project success.
- **Program Management Office Use of Contract Management (CM)**¹² - The CM practices are intended to assist states in maximizing investments in information technology and aid business partners in understanding the state's prescribed processes and methodologies. In addition to providing guidance, the state's Project Management Office (PMO) should provide CM oversight for statewide IT contracts. The three primary elements for effective CM are:
 - Contract Administration and Oversight - a contract manager's role and responsibilities
 - Change Management Processes - processes for managing changes to the contract
 - Dispute Resolution - steps for solving issues

Protecting the State Interests

Beyond the fact that bonds, in high or low amounts, are not incentives for contractors to perform under contract, performance bonds are also not an effective means for protecting the state. Performance bonds are rarely, if ever, paid because years of litigation to determine the amount owed and disputes are usually settled. In addition, the surety does not pay until the dispute has been fully resolved. States have numerous other contractual, legal, and financial remedies to make states "whole" in the event of failure to perform. Figure 3 lists a few remedies that states can use in lieu of performance bonds.

Figure 3 - Remedies in lieu of Performance Bonds



Top 3 Recommendations for Performance Bonds -

In order for states to lower costs and create a competitive procurement pool, performance bonds need to find an appropriate balance based on the likelihood of non-performance and the benefits of robust competition, lower costs, and other remedies for making the state “whole.” Some states may find it in their best interests, or it may be required by law, to have the surety review a contractor’s abilities, reputations, experience, credit, assets, and past performance to bond a contractor. While this process ensures a surety will be there to pay, this is not a guarantee and in many instances only pushes the costs to the states and creates delays. States should consider, if they haven’t already, and several have, the reasons for aligning risk assessments on IT projects and adjusting performance bond requirements if necessary.¹³

1. **A reasonable limitation of the application of the performance bond requirement will increase competition.** States should seek to attract a sufficient quantity of bidders to ensure innovative solutions within budgeted funds.
2. **States have other more effective contractual protections that are more effective than performance bonds, such as service level agreements in appropriate projects, warranties, and acceptance criteria.** Some contractual provisions also operate as sufficient incentives for vendors to perform.
3. **Performance bonds should not be broadly required because, in addition to changes in the claims surety market, the original intent has changed with emerging technologies:**
 - a. Bonds are difficult to secure, time consuming, and expensive to the states.
 - b. Bond collection is rarely triggered under IT services contracts.
 - c. Perhaps most importantly, the Federal government and several states have abandoned the requirement of performance bonds in IT service contracts.

¹ Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

² Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

³ Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

⁴ Business Dictionary, Performance Bond. www.businessdictionary.com/definition/performance-bond.html.

⁵ Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

⁶ Bonds, Bid-Performance-Payment, South Carolina Association of Governmental Purchasing Officials, 2009.

⁷ Example submitted by North Dakota on building a new pension and insurance system for the ND public Employees Retirement System (NDPERS).

⁸ Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

⁹ Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

¹⁰ Performance Bonds as used by the State of California, Information Technology Association of America, April 2006.

¹¹ Georgia Technology Authority, Project Assurance and Independent Verification & Validation (IV&V).

http://gta.georgia.gov/00/channel_modifieddate/0.2096.1070969_144323748.00.html

¹² Maryland Department of Information Technology, Contract Management.

<http://doit.maryland.gov/policies/pages/contractmgmt.aspx>

¹³ Information Technology Association of America (ITAA) Testimony before the Assembly Committee on Business and Professions, Carol Henton, April 24, 2007.

* TechAmerica is the leading voice for the U.S. technology industry. The 1,000+ TechAmerica member companies span the entire spectrum of technology from software to semiconductors and from start-up to multi-national.

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