



Senate Fiscal Agency
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BILL ANALYSIS



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Senate Bill 628 (as reported with amendment)
Senate Bill 629 (as reported with amendments)
Sponsor: Senator Walter H. North
Committee: Local, Urban and State Affairs

Date Completed: 6-20-96

RATIONALE

Public Act 213 of 1963 provides for bonding contractors for public buildings and public works. Under the Act, before any contract exceeding \$50,000 for the construction or repair of a public building or public work of the State or a local unit is awarded, the proposed contractor must furnish to the State or local unit a performance bond and a payment bond that is binding upon the award of the contract. (A performance bond is for the purpose of assuring that a job is completed in the event the general contractor defaults; a payment bond assures subcontractors, who furnish labor, materials, or equipment, of payment if the general contractor fails to pay subcontractors.) It has been pointed out that in some instances in Michigan, payment bonds posted by contractors of public works projects were invalid or insufficient to pay subcontractors or suppliers for work performed or supplies used on the project. Lawsuits filed by subcontractors to recover have produced mixed results, raising questions of whether the Act requires a governmental unit to verify the validity of a general contractor's payment bond. (See BACKGROUND, below.) Some people feel that, regarding the construction or repair of public buildings or public works, it should be the duty of the governmental unit to require that a contractor's payment bond be sufficient and properly executed, and that failure to do so should make the governmental unit liable for failure by the contractor to pay persons entitled to recover under the bond.

CONTENT

The bills would amend two acts to provide that contracts between the State or a local unit of government and a contractor for the construction or repair of public buildings or public works, would require a "good and

sufficient performance and payment bond", meaning a bond properly executed by a surety company authorized by the Insurance Bureau to do business in Michigan. The bills also would provide for the State's or local unit's liability in the event the contractor failed to pay someone entitled to recover under the bond.

Senate Bill 628 would amend Public Act 187 of 1905, which insures the payment of subcontractors, laborers, and suppliers used in the construction or repair of public buildings and public works. Currently, the Act provides that if a project is to be built, repaired, or ornamented under contract at the expense of the State or a local unit (a county, city, village, township, or school district), it is the duty of the governmental unit to require sufficient bond for the payment by the contractor of all subcontractors, labor, and materials. In addition to requiring a good and sufficient performance and payment bond, the bill provides that if the State or a local unit failed to obtain a bond as required by the Act, the State or local unit would be liable for the contractor's or other third party's failure to make payment to any person entitled to recover under the bond; however, the State or local unit would not be liable if the person claiming the right to recover had not performed fully as required by the contract for construction, alteration, or repair.

Currently, a contractor who is a common carrier operating under the Common Carrier Act, or the operator of a State subsidized railroad, may provide an irrevocable letter of credit from a State or national bank or a Federally chartered savings and loan, instead of the required bond. The bill would allow the letter of credit to be provided by a credit union, also.

Senate Bill 629 would amend Public Act 213 of 1963, which provides for bonding contractors for public buildings and public works. In addition to requiring a good and sufficient performance and payment bond, the bill provides that if a governmental unit failed to obtain the required bond, the governmental unit would be liable for a failure by the contractor or other third party to make payment to any person entitled to recover under the bond; however, the governmental unit would not be liable if the person claiming the right to recover had not performed fully as required by the contract for construction, alteration, or repair. ("Governmental unit" refers to the State or a county, city, village, township, school district, public educational institution, other political subdivision, or public agency.)

The bill would require the principal contractor to furnish to each subcontractor, before performance on a contract, a copy of the bond or letter of credit required under the Act. The subcontractor could void its contract with the principal contractor if the principal contractor failed to provide a copy of the bond or letter of credit as required in the bill.

Currently, the payment bond must be in an amount that is at least 25% of the contract amount. The bill would require the bond to be in an amount that was at least 75% of the contract amount.

Currently, a contractor who is a common carrier operating under the Common Carrier Act, or the operator of a State subsidized railroad, may provide an irrevocable letter of credit from a State or national bank or a Federally chartered savings and loan, instead of the required bond. The bill would allow the letter of credit to be provided by a credit union, also.

MCL 570.101 (S.B. 628)
129.201 et al. (S.B. 629)

BACKGROUND

Public Act 213 of 1963 has been the subject of recent court decisions. In 1987 East China Township Schools entered into a general construction contract with Dougherty Construction for construction and renovation of athletic facilities. As required under the Act, Dougherty provided the school district with a performance and payment bond. Dougherty then hired a subcontractor, Kammer Asphalt Paving Co., to perform part of the project. Kammer notified Dougherty and the school district of the work it intended to perform and its reliance upon the payment bond. Though

the school district made progress payments to Dougherty, Dougherty did not make complete payments to Kammer. After complaints by Kammer of Dougherty's failure to compensate the subcontractor, the school district found that the bonds furnished by Dougherty were invalid and unenforceable, and it terminated the contract with Dougherty when Dougherty failed to provide a replacement bond. Kammer filed suit against Dougherty and the school district, claiming that the district was liable for damages since it had failed to ensure the validity of the bond. The St. Clair Circuit Court granted the school district's motion for summary disposition, finding that the statute did not require a governmental unit to ensure the validity of the bonds. The Court of Appeals affirmed the decision of the circuit court. In a split decision, *Kammer Asphalt Paving Co., Inc. v East China Township Schools* (443 Mich 176 (1993)), the Michigan Supreme Court reversed the lower court, allowing Kammer to proceed with its case against the school district. The Supreme Court found that the Act, examined as a whole, "imposes upon a governmental unit the duty to verify the validity of a payment bond" furnished by a general contractor of a public works project.

In April of this year, the Court of Appeals addressed the issue of a governmental unit's duty to require a contractor to furnish a payment bond. In *ABC Supply Company v City of River Rouge* (Docket No. 177719), the Court affirmed a decision of the Wayne Circuit Court, which confirmed a zero dollars arbitration award and an order of summary disposition in favor of the city. The Court of Appeals stated: "We believe the clear language of *Kammer* does not go so far as to construe MCL 129.201...as placing an affirmative duty on the governmental unit to require that the statutory bonds be furnished." (MCL 129.201, which is Section 1 of Public Act 213, provides that before any contract exceeding \$50,000 for the construction or repair of a public building or work is awarded, the contractor must furnish to the governmental unit a performance and a payment bond.) The Court of Appeals stated that the Supreme Court's decision was based, rather, on MCL 129.208 (Section 8 of the Act), which requires a governmental unit to furnish a certified copy of the bond *at the request* of the subcontractor, and provides that the copy is prima facie evidence of the contents, execution, and delivery of the original. The Court of Appeals pointed out a footnote in the *Kammer* decision, in which the Supreme Court said that if Kammer had never requested copies of the bond, it would have had no recourse against the school district: "After

nonpayment by a general contractor, if subcontractors are willing to work without at least requesting copies of the bonds, then they assume the risk that no bonds (or invalid bonds) exist.” The Court of Appeals concluded that the Supreme Court’s holding in *Kammer*, then, “does not provide for a broad duty of the government unit to require the bonds or be liable for parties injured by the failure to require the bonds”.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

When a subcontractor supplies labor, materials, or equipment for a public works project through a contract with the project’s general contractor, the subcontractor should have a reasonable expectation of being paid from the proceeds of the payment bond that the contractor is required by law to furnish, in the event the contractor defaults on the payments. Subcontractors sometimes find too late, however, that the general contractor who didn’t pay a subcontractor for labor or supplies also did not furnish a sufficient or enforceable payment bond. This can result in a legal mess; the subcontractor may feel his or her only recourse is to file suit against the general contractor (who may be insolvent) or against the governmental unit that ordered the project. If the governmental unit has already paid the general contractor, it likely will be reluctant to pay again to satisfy the subcontractor. The question then becomes whether the governmental unit, under Public Act 213, has a duty to verify the validity of the payment bond supplied by the contractor, or is liable for failing to obtain a bond. As seen in recent court cases, this question has not been answered with certainty. The bills would curtail these disputes. They would require a good and sufficient bond properly executed by a surety company authorized by the Insurance Bureau to do business in Michigan, and specify that if a governmental unit failed to obtain the bond as required, it would be liable for a failure by the contractor to make payments to any person entitled to recover under the bond. This would ensure that payment bonds were issued properly, and thus give greater assurance to subcontractors that they would be paid for the labor and supplies they provided.

Opposing Argument

By placing greater responsibility for properly executed performance bonds on the State and

local units of government, the bills would make governmental units liable for the failure of a contractor’s payment bond in nearly all cases. Many local units would be ill-equipped to judge whether a contractor’s payment bond was “properly executed”, or “good and sufficient”. Further, requiring that the payment bond be in an amount equal to at least 75% of the contract amount, rather than the current 25%, would be a significant change. This would result in increased costs for the payment bond, ultimately to be borne by the taxpayer through higher contract amounts.

Legislative Analyst: G. Towne

FISCAL IMPACT

The liability of government entities would increase for public works projects to ensure payments to contractors and subcontractors up to 75% of the contract amount.

Fiscal Analyst: R. Ross

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.