

***CONTRACT SURETY BONDING:
THE AMERICAN EXPERIENCE***

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I WOULD LIKE TO THANK THE SURETY ASSOCIATION OF AMERICA FOR PROVIDING THE REFERENCE MATERIAL UPON WHICH THIS PRESENTATION IS BASED, PARTICULARLY DENNIS WINE, VICE PRESIDENT AND DIRECTOR. I SUGGEST THAT ANYONE DESIRING MORE INFORMATION ON THIS SUBJECT CONTACT HIM AT:

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GOOD MORNING,

I AM HAPPY TO HAVE THE OPPORTUNITY TO RETURN TO BUENOS AIRES BOTH TO ATTEND THIS CONFERENCE AND THE IFRIMA MEETING WHICH WE PLANNED IN SUPPORT OF THIS CONFERENCE. IFRIMA IS THE INTERNATIONAL FEDERATION OF RISK AND INSURANCE MANAGEMENT ASSOCIATIONS, WHICH I SERVE AS PRESIDENT. IFRIMA NOW INCLUDES ALMOST 30 RISK AND INSURANCE MANAGEMENT ASSOCIATIONS FROM OVER 20 COUNTRIES THROUGHOUT THE WORLD. LATIN AMERICA PLAYS A SIGNIFICANT ROLE IN THE LEADERSHIP OF IFRIMA WITH JORGE LUZZI OF ARGENTINA AS EXECUTIVE VICE PRESIDENT AND JORGE LUIS HERNANDEZ OF VENEZUELA AS SECRETARY. AS IT HAS BEEN MANY YEARS SINCE I WAS FLUENT IN SPANISH, I WILL REVERT TO MY NATIVE ENGLISH AND RELY ON OUR TRANSLATORS. HOWEVER, I HAVE COPIES OF THIS PRESENTATION AVAILABLE FOR YOU IN BOTH SPANISH AND PORTUGUESE.

WHEN JORGE LUZZI ASKED ME TO SPEAK ABOUT THE AMERICAN EXPERIENCE WITH SURETY BONDING, I TOLD HIM IT WOULD GIVE ME THE OPPORTUNITY TO RETURN TO WHERE I HAD STARTED IN THE BUSINESS ALMOST TWENTY FIVE YEAR'S AGO. IN JUNE OF 1972, I BEGAN MY FIRST JOB IN INSURANCE AS A SURETY AND FIDELITY BOND UNDERWRITING TRAINEE AT WHAT WAS THEN THE INA.

THE ORIGINS OF THE CONCEPT OF SURETYSHIP ARE ANCIENT. IN THE BOOK OF GENESIS JUDAH GUARANTEES THE PERFORMANCE OF HIS BROTHER TO HIS FATHER. ALSO IN THE BIBLE, BENJAMIN WARNS SOLOMON THAT ‘HE WHO GUARANTEES A STRANGER SHALL SUFFER FOR IT.’ SURETY IS ALSO REFERENCED IN THE CODE OF HAMMURABI, HERODOTUS AND THE MAGNA CARTA.

PERHAPS THE MOST NOTEWORTHY REFERENCE TO SURETYSHIP IS IN SHAKESPEARE’S “MERCHANT OF VENICE” IN WHICH THE PLOT CENTERS ON THE CONTRACT OF SURETYSHIP BETWEEN ANTONIO AND SHYLOCK. UNDER WHAT WAS ESSENTIALLY A SURETY BOND, SHYLOCK WAS TO TAKE A POUND OF ANTONIO’S FLESH IF ANTONIO’S FRIEND BASSANIO WAS UNABLE TO PAY HIS OBLIGATION TO SHYLOCK ON THE DATE DUE. SINCE THAT TIME SURETY PENALTIES HAVE BECOME SOMEWHAT LESS DRAMATIC.

THERE ARE MANY DIFFERENT KINDS OF SURETY BONDS ADDRESSING MANY SITUATIONS IN WHICH ONE PARTY MAY LOOK TO A THIRD PARTY TO GUARANTEE PERFORMANCE AND/OR PAYMENT BY ANOTHER. IT IS IMPORTANT TO DISTINGUISH BETWEEN INSURANCE AND SURETYSHIP. A LIABILITY INSURER, FOR EXAMPLE, MAY PAY AN INJURED THIRD PARTY ON BEHALF OF THE INSURED. THE INSURED IS THUS PROTECTED BY THE INSURER. UNDER A SURETY BOND THE SURETY MAY GUARANTEE THE PERFORMANCE OF A CONTRACTOR, FOR EXAMPLE, TO A PROJECT OWNER, HOWEVER, THE SURETY HAS FULL RECOURSE

AGAINST THE CONTRACTOR CORPORATION AND USUALLY ALSO AGAINST ITS PRINCIPALS INDIVIDUALLY. IN SHORT THE SURETY BOND PROTECTS THE PROJECT OWNER NOT THE CONTRACTOR.

MY FOCUS TODAY WILL BE ON BONDS UTILIZED IN CONSTRUCTION PROJECTS. A CENTURY AGO IN THE UNITED STATES THE FEDERAL GOVERNMENT BECAME CONCERNED ABOUT THE HIGH RATE OF FAILURE AMONG PRIVATE CONTRACTORS PERFORMING PUBLIC CONSTRUCTION PROJECTS. THE GOVERNMENT DISCOVERED THAT THESE CONTRACTORS WERE OFTEN ALREADY INSOLVENT WHEN THE JOB WAS AWARDED OR WERE DESTINED TO BECOME INSOLVENT BEFORE THE PROJECT COULD BE FINISHED. AS A RESULT THE GOVERNMENT WAS OFTEN LEFT WITH UNFINISHED PROJECTS AND TAXPAYERS HAD TO BEAR THE ADDITIONAL COSTS OF COMPLETION.

SINCE GOVERNMENT PROPERTY IS NOT SUBJECT TO MECHANIC'S LIENS, THE LABORERS, MATERIAL SUPPLIERS AND SUBCONTRACTORS WERE WITHOUT REMEDY WHEN THEY WERE NOT PAID FOR THEIR SERVICES.

AS A RESULT OF THESE CIRCUMSTANCES, IN 1894, THE UNITED STATES CONGRESS PASSED THE HEARD ACT WHICH AUTHORIZED THE USE OF CORPORATE SURETY BONDS TO SECURE PRIVATELY PERFORMED FEDERAL CONSTRUCTION PROJECTS. BY 1908 SURETY COMPANIES WERE WRITING ANNUAL PREMIUMS IN EXCESS OF 11 MILLION DOLLARS. AT THAT TIME

REPRESENTATIVES OF 13 MAJOR SURETY COMPANIES FORMED THE SURETY ASSOCIATION OF AMERICA TO PROVIDE A DEGREE OF SELF-REGULATION FOR THE INFANT INDUSTRY, TO REPRESENT THE INTERESTS OF MEMBER COMPANIES AND TO ESTABLISH A BASIS FOR FIDELITY AND SURETY RATE MAKING. TODAY THE SURETY ASSOCIATION OF AMERICA INCLUDES OVER 500 AMERICAN SURETY COMPANIES AND FOUR FOREIGN AFFILIATES. IN 1935, THE HEARD ACT WAS REPLACED BY THE MILLER ACT, WHICH IS THE CURRENT LAW REQUIRING PERFORMANCE AND PAYMENT BONDS ON FEDERAL CONSTRUCTION PROJECTS. IT IS IMPORTANT TO REITERATE THAT BID, PERFORMANCE AND PAYMENT BONDS ARE NOT INTENDED TO PROTECT THE CONTRACTORS THAT HAVE TO POST THEM. INSTEAD THESE BONDS ARE INTENDED TO PROTECT THE OWNER OF THE CONSTRUCTION PROJECT AGAINST THE FAILURE OF THE CONTRACTOR AND TO PROTECT CERTAIN LABORERS, MATERIAL SUPPLIERS AND SUBCONTRACTORS AGAINST NON-PAYMENT. I HAVE ALREADY INTRODUCED SOME TERMS WHICH I HAVE YET TO DEFINE. WHAT EXACTLY ARE BID, PERFORMANCE AND PAYMENT BONDS?

THE BID BOND GUARANTEES THAT THE BID FOR THE PROJECT HAS BEEN SUBMITTED IN GOOD FAITH, THAT THE CONTRACTOR WILL ENTER INTO THE CONTRACT AT THE PRICE BID AND WILL SUBSEQUENTLY PROVIDE THE REQUIRED PERFORMANCE AND PAYMENT BONDS. IT ALSO PROTECTS THE OWNER FOR THE

DIFFERENCE BETWEEN THE GUARANTEED BID AND THE NEXT HIGHEST BID.

THE PERFORMANCE BOND PROTECTS THE PROJECT OWNER FROM FINANCIAL LOSS SHOULD THE CONTRACTOR FAIL TO CARRY OUT ITS OBLIGATIONS UNDER THE CONTRACT. IN THE EVENT OF CONTRACTOR INSOLVENCY THE SURETY MAY CHOOSE TO PROVIDE AN INFUSION OF CAPITAL OR ARRANGE FOR AN ALTERNATIVE CONTRACTOR TO FINISH THE PROJECT.

THE PAYMENT BOND GUARANTEES THAT THE CONTRACTOR WILL PAY CERTAIN SUBCONTRACTOR, LABOR AND MATERIAL BILLS ASSOCIATED WITH THE PROJECT. OBLIGATIONS, WHICH ON PRIVATE PROJECTS, MAY OTHERWISE REVERT TO THE PROJECT OWNER.

THE SURETY UNDERWRITER DOES NOT ASSUME SUCH SERIOUS OBLIGATIONS WITHOUT EXTENSIVE ANALYSIS. IN FACT THE RELATIONSHIP BETWEEN A CONTRACTOR AND ITS SURETY TENDS TO BE VERY LONG TERM, SIMILAR TO A BANKING RELATIONSHIP.

WHEN INITIALLY REVIEWING A CONTRACTOR BY PERFORMING WHAT IS REFERRED TO AS PREQUALIFICATION FOR BONDING, THE SURETY WILL REQUIRE EXTENSIVE INFORMATION.

- AN ORGANIZATION CHART INDICATING KEY EMPLOYEES, THEIR RESPONSIBILITIES AND DETAILED RESUMES.**

- **A BUSINESS PLAN OUTLINING THE TYPE OF WORK BEING PERFORMED, HOW JOBS ARE OBTAINED, THE GEOGRAPHIC SCOPE OF OPERATION, HISTORIC GROWTH AND PROFIT PROJECTIONS.**
- **A DESCRIPTION OF THE LARGEST COMPLETED JOBS INCLUDING THE NAMES AND ADDRESSES OF THE PROJECT OWNERS, THE CONTRACT PRICES, DATES OF COMPLETION AND GROSS PROFITS EARNED.**
- **A PLAN DETAILING HOW THE BUSINESS WOULD CONTINUE IN THE EVENT OF THE DEATH OR DISABILITY OF KEY PERSONNEL (THE SURETY MAY REQUIRE THAT THE CONTRACTOR CORPORATION PURCHASE LIFE INSURANCE ON KEY PEOPLE WITH THE CONTRACTOR CORPORATION NAMED AS BENEFICIARY).**
- **REFERENCES FROM SUBCONTRACTORS AND SUPPLIERS WILL ALSO BE REQUIRED TOGETHER WITH AN INDEPENDENT CREDIT REPORT.**
- **EVIDENCE OF A BANK LINE OF CREDIT WILL ALSO BE REQUESTED (SURETIES GENERALLY LOOK FOR AN UNSECURED LINE OF CREDIT THAT CAN BE USED WHEN NEEDED TO MEET SHORT TERM CASH REQUIREMENTS. THE SURETY MAY ALSO**

WANT TO SEE AN ADDITIONAL SECURED LINE OF CREDIT OBTAINED THROUGH THE LONG TERM FINANCING OF EQUIPMENT OR REAL ESTATE)

- **FINALLY THE SURETY WILL WANT TO REVIEW LETTERS OF RECOMMENDATION FROM OWNERS, ARCHITECTS AND ENGINEERS.**

THE SURETY'S FINANCIAL ANALYSIS IS ALSO EXTENSIVE. GENERALLY A SURETY WILL REQUIRE AUDITED FINANCIAL STATEMENTS INCLUDING:

- **THE BALANCE SHEET EVIDENCING ASSETS, LIABILITIES, AND NET WORTH.**
- **THE INCOME STATEMENT DETAILING GROSS PROFIT ON CONTRACTS, OPERATING PROFIT AND NET PROFIT BEFORE AND AFTER TAXES.**
- **A STATEMENT OF CASH FLOW DISCLOSING CASH FLOW MOVEMENTS FROM OPERATING, INVESTING AND FINANCING ACTIVITIES.**
- **A SCHEDULE OF CONTRACTS IN PROGRESS AND COMPLETED. THIS PERMITS THE SURETY TO EVALUATE WHETHER THE JOB BEING BID IS CONSISTENT WITH THE CONTRACTOR'S**

EXPERIENCE AND IF THE CONTRACTOR IS BECOMING OVER EXTENDED.

- **A SCHEDULE OF GENERAL ADMINISTRATIVE EXPENSES, WHICH INDICATES HOW WELL OVERHEAD IS BEING CONTROLLED AND MANAGED.**
- **ANY EXPLANATORY NOTES THE ACCOUNTANT MAY HAVE INCLUDED WITH THE FINANCIAL STATEMENTS. THE SURETY MAY ALSO REQUIRE SCHEDULES OF ACCOUNTS RECEIVABLE AND PAYABLE AS WELL AS FURTHER DETAIL ON ANY OF THE OTHER ITEMS INCLUDED IN THE FINANCIAL STATEMENTS.**
- **FINALLY ASSUMING ALL OTHER CONDITIONS HAVE BEEN MET, THE SURETY WILL REQUIRE THE FORMAL INDEMNITY OF THE CONTRACTING FIRM FOR ANY LOSS THE SURETY MAY INCUR. THE SURETY WILL ALSO OFTEN REQUIRE PERSONAL INDEMNITIES FROM THE OWNERS OF THE CONTRACTOR CORPORATION AND THEIR SPOUSES.**

SOME PROJECT OWNERS CONCLUDE THAT IF A CONTRACTOR CAN MEET ALL OF THE REQUIREMENTS OF A SURETY SUCH THAT THE SURETY COMMITS TO PROVIDING THE BID, PERFORMANCE AND PAYMENT BONDS, THAT THEY CAN SAVE MONEY BY ONLY GETTING A BID BOND. THE BID BOND IS USUALLY PROVIDED WITHOUT CHARGE OR FOR A NOMINAL FEE. HOWEVER, AS MR. THOMAS GORKE OF THE ST. PAUL INSURANCE COMPANY, WHO IS

ALSO VICE CHAIRMAN OF THE SURETY ASSOCIATION OF AMERICA, POINTS OUT “SURETY UNDERWRITERS MAKE MISTAKES AND CONTRACTOR’S FORTUNES CAN CHANGE ALMOST OVERNIGHT. OVER 4 BILLION DOLLARS IN LOSSES HAVE BEEN PAID BY SURETY COMPANIES ON BONDED PROJECTS OVER THE LAST DECADE. IF THE PERFORMANCE BONDS HAD BEEN WAIVED, THESE HUGE LOSSES WOULD HAVE BEEN BORNE BY THE PROJECT’S OWNERS RATHER THAN THE SURETY COMPANIES.”

SOME SUGGEST THAT BANK LETTERS OF CREDIT ARE A SUITABLE ALTERNATIVE TO SURETY BONDS. LETTERS OF CREDIT SERVE A LIMITED PURPOSE, HOWEVER, THERE ARE MAJOR DIFFERENCES BETWEEN LETTERS OF CREDIT AND SURETY BONDS, WHICH THE PROJECT OWNER SHOULD CONSIDER, PARTICULARLY IF THE COSTS OF BOTH ARE COMPARABLE. WITH RESPECT TO COST, I HAVE ALREADY NOTED THAT THE SURETY PROVIDES THE BID BOND WITHOUT CHARGE OR FOR A VERY NOMINAL FEE IN ANTICIPATION OF WRITING THE PAYMENT AND PERFORMANCE BONDS. THE TOTAL COST OF BOTH THE PAYMENT AND PERFORMANCE BONDS TOGETHER RUNS FROM 1 TO 3 PERCENT OF THE CONTRACT COST. LARGER CONTRACTS ARE CHARGED AT THE LOWER END OF THE RANGE OR APPROXIMATELY 1%. THE COST OF A LETTER OF CREDIT APPEARS COMPARABLE AT 1% OF THE AMOUNT OBTAINED. HOWEVER, THE PAYMENT AND PERFORMANCE BONDS ARE EACH WRITTEN TO THE FULL AMOUNT OF THE CONTRACT. TO EVEN BEGIN TO HAVE COMPARABLE DOLLAR PROTECTION THE LETTER OF CREDIT WOULD HAVE TO BE

WRITTEN FOR 150 TO 200% OF THE CONTRACT COST. THIS IS IN FACT THE REQUIRED LEVEL OF A LETTER OF CREDIT WHEN USED IN LIEU OF A SURETY BOND ON FEDERAL PROJECTS IN THE U.S. ON OTHER TYPES OF PROJECTS, LETTERS OF CREDIT SOMETIMES APPEAR TO BE CHEAPER THAN SURETY BONDS, HOWEVER, THAT IS OFTEN BECAUSE THEY ARE ONLY WRITTEN FOR A SMALL PERCENTAGE OF THE CONTRACT PRICE.

SURETY BONDS AND LETTERS OF CREDIT ARE QUITE DIFFERENT INSTRUMENTS. THE PERFORMANCE BOND IS DIRECTLY TIED TO THE UNDERLYING CONSTRUCTION CONTRACT AND RESPONDS IF THE CONTRACTOR DEFAULTS IN CARRYING OUT ITS DUTIES. THE SURETY COMPANY HAS A NUMBER OF DUTIES AND RESPONSIBILITIES TO THE PROJECT OWNER. THIS CONTRASTS SHARPLY WITH A LETTER OF CREDIT, WHICH SIMPLY PAYS OVER A SUM OF MONEY ON DEMAND. THERE ARE MANY OTHER DIFFERENCES BETWEEN THE CIRCUMSTANCES SURROUNDING AND THE PROTECTION AFFORDED BY A SURETY BOND AS OPPOSED TO A LETTER OF CREDIT.

I HAVE ALREADY DESCRIBED THE VERY EXTENSIVE PREQUALIFICATION ANALYSIS THAT OCCURS BEFORE A SURETY WILL AGREE TO PROVIDE A BOND. IN CONTRAST A BANK MAY SIMPLY SATISFY ITSELF AS TO THE ADEQUACY OF AVAILABLE COLLATERAL BEFORE ISSUING A LETTER OF CREDIT.

IF A CONTRACTOR SHOULD DEFAULT, THE SURETY HAS A VARIETY OF OPTIONS. THE SURETY MAY STEP IN AND PROVIDE ADDITIONAL CAPITAL TO THE ORIGINAL CONTRACTOR AND PROVIDE OTHER SUPPORT NECESSARY FOR THE CONTRACTOR TO COMPLETE THE PROJECT OR THE SURETY MAY ARRANGE FOR A NEW CONTRACTOR TO FINISH THE PROJECT. THE SURETY RARELY ELECTS TO SIMPLY PAY THE SUM OF THE BOND BECAUSE THE ABOVE DESCRIBED ALTERNATIVES ARE USUALLY MORE COST EFFECTIVE AND ALSO RESULT IN A SUCCESSFULLY COMPLETED PROJECT.

UNDER A LETTER OF CREDIT, UPON THE DEFAULT OF THE CONTRACTOR THE BANK WILL PAY THE PROJECT OWNER THE PREDETERMINED SUM OF MONEY, THE TASK OF ADMINISTERING THE COMPLETION OF THE PROJECT REMAINS WITH THE OWNER.

WHEN PERFORMANCE AND PAYMENT BONDS ARE USED IN THE PRIVATE SECTOR ANY CLAIMS FOR PAYMENT BY SUBCONTRACTORS, MATERIAL SUPPLIERS, LABORERS ARE HANDLED BY THE SURETY. UNDER A LETTER OF CREDIT, ALL SUCH CLAIMS AND DISPUTES MUST BE HANDLED BY THE PROJECT OWNER.

THERE IS ALSO A DIFFERENCE IN TERMS OF DURATION BETWEEN BONDS AND LETTERS OF CREDIT. PERFORMANCE AND PAYMENT BONDS REMAIN IN FORCE SUBJECT TO THEIR TERMS AND CONDITIONS, THE CONTRACT DOCUMENTS AND THE UNDERLYING

STATUTES. THE PROJECT OWNER DOES NOT HAVE TO MAKE A DECISION ON THE RELEASE OF THE PERFORMANCE BOND.

WITH A LETTER OF CREDIT, THE PROJECT OWNER MUST DECIDE WHEN THE LETTER CAN BE RELEASED, FOR EXAMPLE, EVEN IF THE ACTUAL CONSTRUCTION IS COMPLETED, THERE MAY BE A ONE YEAR WARRANTY FOR DEFECTIVE MATERIALS AND WORKMANSHIP. ANOTHER QUESTION ARISES WITH RESPECT TO STATUTES OF LIMITATION. IF THE LETTER OF CREDIT IS RELEASED, WHAT RECOURSE DOES THE OWNER HAVE IF LATENT DEFECTS ARE DISCOVERED? IF THE OWNER WANTS TO PROTECT CLAIMANTS, THE LETTER OF CREDIT WOULD HAVE TO STAY IN EFFECT UNTIL THE TIME FOR FILING NOTICES AND/OR BRINGING SUIT HAD ELAPSED AND THIS MAY INVOLVE ADDITIONAL CHARGES.

FINALLY, AS WE HAVE NOTED, THERE ARE ALSO IMPORTANT DIFFERENCES BETWEEN BONDS AND LETTERS OF CREDIT IN TERMS OF THE AMOUNTS OF COVERAGE.

PERFORMANCE AND PAYMENT BONDS ARE GENERALLY EACH IN AN AMOUNT EQUAL TO 100% OF THE CONTRACT PRICE. THIS AFFORDS THE PROJECT OWNER 100% PROTECTION FOR THE PERFORMANCE OF THE CONTRACT AND, IN ADDITION, PROVIDES PAYMENT BOND CLAIMANTS PROTECTION EQUAL TO 100% OF THE CONTRACT PRICE.

FOR A LETTER OF CREDIT TO PROVIDE COMPARABLE FINANCIAL PROTECTION IT WOULD HAVE TO BE WRITTEN TO AN AMOUNT APPROACHING 200% OF THE CONTRACT PRICE, WHICH MAY BE A COST PROHIBITIVE APPROACH.

ACCORDING TO THE BUSINESS ROUNDTABLE, CONSTRUCTION IN THE U.S. IS A 445 BILLION DOLLAR INDUSTRY COMPRISING NEARLY 1 MILLION CONTRACTORS, MORE THAN 70 NATIONAL CONTRACTOR ASSOCIATIONS AND SOME 6.5 MILLION WORKERS. ACCORDING TO DUN & BRADSTREET SIXTY THOUSAND CONTRACTORS FAILED OVER THE PAST TEN YEARS LEAVING UNFINISHED PRIVATE AND PUBLIC SECTOR PROJECTS OF 18.4 BILLION DOLLARS.

SURETY BONDS PLAY AN IMPORTANT ROLE IN ALLOWING PROJECT OWNERS TO ADDRESS THESE RISKS. SURETY COMPANIES IN THE UNITED STATES HAVE COME A LONG WAY SINCE THEIR FORMATION ALMOST 100 YEARS AGO. THE TOTAL ANNUAL PREMIUMS EARNED BY SURETY COMPANIES FROM ALL TYPES OF BONDS HAS GROWN FROM THE 1908 NUMBER OF 11 MILLION DOLLARS TO THE 1995 NUMBER OF 2.5 BILLION DOLLARS WITH A LOSS RATIO OF 25%.

CERTAINLY AS INFRASTRUCTURE AND OTHER MAJOR CONSTRUCTION PROJECTS ARE CONTEMPLATED IN LATIN AMERICA SERIOUS CONSIDERATION SHOULD BE GIVEN TO THE POTENTIAL VALUE OF SURETY BONDS.

THANK YOU,

GRACIAS

**IF THE NUMBER OF COPIES IN SPANISH AND PORTUGUESE IS
INSUFFICIENT PLEASE LEAVE A BUSINESS CARD INDICATING THE
LANGUAGE DESIRED AND I WILL FORWARD IT TO YOU.**