Statement of:

THE NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS (NASBP)
&
THE SURETY & FIDELITY ASSOCIATION OF AMERICA (SFAA)

To the U.S. House of Representatives
Committee on Small Business
RE: Hearing on
“CONTRACTING AND THE INDUSTRIAL BASE”

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The Surety & Fidelity Association of America
Serving the Industry Since 1908

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The National Association of Surety Bond Producers (NASBP) is a national trade association of firms employing licensed surety bond producers who place bid, performance, and payment bonds throughout the United States and its territories.

The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship. SFAA member companies collectively write the majority of surety and fidelity bonds in the United States. The SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety data.

Our written statement begins with a brief description of the important role surety bonds play in the federal procurement arena. Our statement then addresses our support of three bills introduced in the 112th and 113th Congresses, H.R. 3534 and H.R. 776, and H.R. 838. H.R. 838 was introduced in the 114th Congress on February 10, 2015, by Representative Richard Hanna, and cosponsored by the Chairman of the House Small Business Committee, Steve Chabot and Representative Grace Meng. These bills concern the use of individual surety bonds on federal construction projects and reforms to the Small Business Administration's (SBA) Surety Bond Guarantee Program, and are representative of needed legislation on small business matters that NASBP and SFAA wish to bring to the attention of the Committee on Small Business for support.

The Importance of Surety Bonds: Sound Public Policy

Corporate surety bonds are three-party contract agreements by which one party (a surety company) guarantees or promises a second party (the obligee/federal government) the successful performance of an obligation by a third party (the principal/contractor). In deciding to grant surety credit, the surety underwriter conducts in-depth analysis, also known as prequalification, of the capital, capacity, and character of the construction firm during the underwriting process to determine the contractor's ability to fulfill contractual commitments. Surety bonds are an essential means to discern qualified construction companies and to guarantee contracts and payments, ensuring that vital public projects are completed, subcontracting entities are paid, and jobs are preserved.

The federal government has relied on surety bonds for prequalification of construction contractors and for performance and payment assurances since the late nineteenth century. In 1894, the U.S. Congress passed the Heard Act which codified the requirement for surety on U.S. government contracts and institutionalized the business of surety. In 1935, the Heard Act was superseded by the Miller Act, which required the continuation of these vital assurances so that U.S. taxpayer funds were protected and subcontractors and suppliers would receive payment for their labor and materials. Currently, the federal Miller Act requires performance and payment bonds from prime contractors awarded construction contracts exceeding $150,000.00, and payment security for contracts between $30,000.00 and $150,000.00.

Types of Surety Bonds
The bid bond assures that the bid has been submitted in good faith and the contractor will enter into the contract at the bid price and provide the required performance and payment bonds. A performance bond protects the project owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. The payment bond protects subcontractors and suppliers, which do not have direct contractual agreements with the public owner and which would be unable to recover lost wages or expenses should the contractor be unable to pay its financial obligations. Often, small construction businesses must access the federal procurement marketplace at subcontractor and supplier levels, and the payment bond is their primary recourse and protection in the event of prime contractor nonpayment or insolvency.

The Construction Industry Supports of H.R. 3534 (112th Congress) H.R. 776 (113th Congress) and H.R. 838 (114th Congress)
NASBP and SFAA along with many other organizations such as: the American Council of Engineering Companies (ACEC), the Associated General Contractors of America (AGC), the American Institute of Architects (AIA), the American Subcontractors Association (ASA), the Mechanical Contractors Association of America (MCAA), the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA), the Construction Financial Management Association (CFMA), and the American Insurance Association (AIA), view H.R. 3534, H.R. 776, and H.R 838 as critical means (1) to protect taxpayers, federal contracting entities, and construction businesses by assuring the integrity of surety bonds on federal contracts when issued by unlicensed individuals using a pledge of assets and (2) to provide additional opportunities for small and emerging construction contractors, which otherwise do not qualify for surety credit in the standard market, to utilize the Surety Bond Guarantee Program of the US Small Business Administration, so that such businesses will receive surety credit from regulated markets.

Enact legislation to protect taxpayers, and small businesses
Every contractor that bids and obtains a federal construction contract must secure its obligations under that contract. The most common form of security is a surety bond from a certified and approved surety insurance company. As noted earlier, the Federal Miller Act requires contractors to furnish surety bonds on federal construction projects to ensure that prospective contractors are qualified to undertake federal construction contracts and that bonded contracts will be completed in the event of a contractor default, thereby protecting precious U.S. taxpayer dollars and subcontractors and suppliers, many of which are small businesses. The financial strength and stability of the surety is the key to the success of the surety bonding system.

Presently, there are three methods construction firms may use to furnish security on a federal construction project:

1. By securing a bond written by a corporate surety, that is vetted, approved, and audited by the U.S. Department of Treasury and listed in its Circular 570;
2. By using their own assets to post an "eligible obligation," i.e. a U.S.-backed security, in lieu of a surety bond. The security is pledged directly and deposited with the federal government until the contract is complete; or

3. By securing a bond from an unlicensed individual, if the bond is secured by an "acceptable asset," which includes stocks, bonds, and real property owned in fee simple.

It is this third alternative that has proven consistently problematic to the financial detriment of contracting authorities and of subcontractors and suppliers performing on federal projects. NASBP, SFAA, along with the other organizations supporting these bills, believe, based on substantial evidence and past testimony, that the current regulations pertaining to use of individual sureties on federal construction projects are fundamentally flawed, allowing gamesmanship by unlicensed persons acting as sureties. Such existing requirements need to be superseded by the statutory approach delineated in H.R. 3534/776/838.

Federal Acquisition Regulation (FAR) 28.203-2(b)(3) permits federal contracting officers to accept bonds from natural persons, not companies, if the bond is secured by an "acceptable asset," which includes stocks, bonds, and real property. These individuals neither are subject to the same scrutiny and vetting given to corporate sureties nor are they required to provide physical custody of the asset to the government that they pledge to secure their bonds to the contracting authority.

This lack of thorough scrutiny of individual sureties and control over their pledged assets has resulted in a number of documented situations where assets pledged by individual sureties have proven to be illusory or insufficient, causing significant financial harm to the federal government, to taxpayers, and to subcontractors and suppliers, many of whom are small businesses wholly reliant on the protections of payment bonds to safeguard their businesses.

Federal requirements do mandate a level of documentation and information from individual sureties. Individual sureties are required to complete, sign, and have notarized an affidavit of individual surety (SF 28), which is a standardized form for the purpose of eliciting a description of the assets pledged and the contracts on which they are pledged. SF 28, however, does not elicit other pertinent information, such as that about the character or fitness of the individual acting as surety, like criminal convictions, state insurance commissioner cease and desist orders, outstanding tax liens, or personal bankruptcies.

Under FAR requirements, the pledged assets also are supposed to be placed in an escrow arrangement by the individual surety, subject to the approval of the contracting officer. The individual surety, however, is not required to turn the assets over to the physical care and custody of the contracting authority. Each contracting officer, not the Department of Treasury, shoulders the entire burden of determining the acceptability of the individual surety, its documentation, the escrow or security arrangement, and the value and adequacy of pledged assets, and must do so in relatively short order to progress the contract procurement. A missed, incorrect, or forsaken step may mean the acceptance of a fraudulent or insufficient bond, rendering its apparent and much needed protection worthless.

This burden of assessing individual sureties is added to the already considerable responsibilities of contracting officers. They are required to determine the authenticity of the documentation of the assets pledged to support the individual surety's bond obligations and to verify that the pledged assets actually exist, are sufficient, and are available to the federal government. They have to know that a particular financial document is what it purports to be and to understand and to assess the different types of collateral, such as stocks and real estate located anywhere in the United States.

It is not clear if and how often federal contracting officers receive specific training to understand and to perform the needed tasks of examination concerning individual sureties. Documents of federal agencies suggest that there are occasions when federal contracting officers may not have a complete understanding of what is required of them to safeguard taxpayers and small businesses from individual surety fraud. The Financial Management Service of the U.S. Department of Treasury issued a "Special Informational Notice to All Bond-Approving (Contracting) Officers"[1] on February 3, 2006, still posted at http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/special_notice.pdf. This informational notice was directed to federal contracting officers to remind them of the applicable FAR requirements governing individual sureties. Specifically, the notice, a copy of which is attached to this testimony, states in part:

> *"Although FMS is not substantively responsible for approving individual sureties, we believe it prudent to issue this Special Informational Notice on a FYI basis to Agency Bond-Approving (Contracting) Officers who do have that responsibility under the FAR.*
>
> *Recently, FMS has been made aware of instances where individual sureties are listing corporate debenture notes and other questionable assets on their 'Affidavit of Individual Surety', Standard Form 28. In some instances, the individual sureties used a form other than the Standard Form 28 as their affidavit."*

Likewise, the U.S. Department of the Interior issued a notice to its contracting officers in 2009 to remind them of FAR requirements associated with acceptance of individual surety bonds. This notice, titled "Department of the Interior Acquisition Policy Release (DIAPR) 2009-15," states that the Department of the Interior Office of Inspector General conducted an investigation of contracting personnel practices concerning individual sureties and found concerns.[2] Specifically, the release, a copy of which is attached to this testimony, states in part:

> *"The investigation identified several areas of concern that require our attention. There is concern that Contracting Officers (COs) are: (1) unfamiliar with the FAR requirements for individual surety; (2) accepting individual surety bonds without knowing or verifying the assets backing*

[1] United States. Treasury Department. Financial Management Service. "Special Informational Notice to All Bond-Approving (Contracting) Officers". February 3, 2006.
[2] United States. Department of the Interior. "Department of the Interior Acquisition Policy Release (DIAPR) 2009-15". September 8, 2009.

the bonds; (3) not vetting questions about individual surety bonds through the DOI Office of the Solicitor; and (4) not verifying individual sureties against the General Services Administration's Excluded Parties List System."

If a contracting officer fails to perform adequately the necessary investigation of an individual surety, and the individual surety pledges assets that do not exist, are insufficient, or are not readily convertible into cash to pay the obligations of the defaulted general contractor, everyone on the project from the contracting agency on down is left unprotected and at risk for financial loss. If the assets pledged to support the bonds are uncollectible, unpaid subcontractors and suppliers protected by the bond, many of which typically are small businesses, will suffer financial hardship and could, in turn, default and become insolvent.

Examples of Improper Individual Surety Activity

There is no one place to go to find statistical data on individual surety problems because individual sureties typically operate outside of state insurance regulatory structures, despite the fact that they are required under almost all state insurance codes to obtain certificates of authority to act as a surety insurer from state insurance commissioners. Moreover, the federal government does not require individual sureties writing bonds on federal contracts to furnish proof of licensure or authority to operate in a state jurisdiction as a surety insurer. Consequently, little or no regulatory oversight may ever be exercised over persons acting as individual sureties on federal projects apart from the modicum of scrutiny undertaken, if at all, by the federal contracting officer.

Nonetheless, in recent years, illustrations of individual surety problems abound. These situations usually involve individual surety bond assets that turned out to be inadequate, illusory, or unacceptable. One illustration is *United States ex rel. JBlanco Enterprises Inc. v. ABBA Bonding, Inc,* where, in spite of a March 11, 2005 cease and desist order from the Alabama Insurance Department, Mr. Morris Sears, doing business as ABBA Bonding, was able to submit bonds on a federal contract in Colorado supported by an affidavit (Standard Form 28) stating that ABBA Bonding had assets with a net worth of over $126 million. Although no assets were placed in escrow for the benefit of the government, the U.S. General Services Administration accepted the bonds anyway. JBlanco Enterprises, a small business 8a subcontractor performing work on federal contracts, nearly was forced to declare bankruptcy as a result of a deficient individual surety bond placed by Mr. Sears on a federal project that later proved to have no assets to support the bond. Ms. Jeanette Wellers, a principal of JBlanco Enterprises, provided oral and written testimony[3] about this situation during a hearing on H.R. 3534.

Sears eventually sought bankruptcy protection against numerous creditors (100+) arising from defaulted bond obligations, including protection against bond debts owed to three federal contracting agencies. Chief Bankruptcy Judge Margaret A. Mahoney, U.S. Bankruptcy Court, Southern District of Alabama held that Sears had "knowingly made

[3] Wellers, Jeanette. Written Testimony before U.S. House Committee on the Judiciary Subcommittee on Courts, Commercial and Administrative Law. March 5, 2012.

misrepresentations regarding collateral he pledged in support of surety bonds."[4] Judge Mahoney also found that Sears falsely stated that the real estate had not been pledged to any other bond contract within three years prior to the execution of any Affidavit and that Sears made misrepresentations to numerous agencies. Thus, the Bankruptcy Court determined that that Sears' debts to the government were nondischargeable. His false statements then formed the basis of a criminal indictment against Sears, who died while undergoing criminal prosecution in the U.S. District Court for the South District of Alabama.

In another example, Edmund Scarborough, the owner of IBCS Fidelity, another individual surety, filed for bankruptcy in Tampa, Florida. IBCS issued countless individual surety bonds on federal, state, and private construction projects using suspect assets. In his bankruptcy petition, Scarborough listed $4.5 million in assets and $16.2 million in liabilities; IBCS had used a speculative commodity, mined coal waste, which it valued at $191 million, to back its individual surety bonds. That mined coal waste was valued at $120,000 in the bankruptcy filing.[5]

The above individuals operated nationally and across state boundaries, victimizing public and private entities, small construction businesses, and businesses of all sizes. These examples, unfortunately, are not isolated instances. Other examples exist, both past and present, showing where individual surety bond assets proved illusory, uncollectible, or deficient. More businesses, many of whom are likely to be small businesses, will be victimized unless Congress acts to correct these flawed requirements, which permit unscrupulous individuals, many with criminal, personal insolvency, and tax lien histories, to issue worthless surety bonds on taxpayer-funded federal construction contracts.

Common-Sense Legislative Solution

Legislation like H.R. 3534, H.R.776, and H.R 838 are simple, common-sense legislative solutions that will eliminate opportunities for fraud by mandating that real assets be placed in the care and custody of the contracting authority. These bills require individual sureties to pledge solely those assets defined as eligible obligations by the Secretary of the Treasury. An eligible obligation is a public debt obligation of the U.S. Government and an obligation whose principal and interest is unconditionally guaranteed by the U.S. Government, such as U.S. Treasury bills, notes, and bonds, certain HUD government guaranteed notes and certificates, and certain Ginnie Mae securities, among other federally guaranteed securities. These safe and stable assets then are provided to the federal contracting authority, which will deposit them in a federal depository designated by the Secretary of the Treasury, ensuring that pledged assets are real, sufficient, convertible, and in the physical custody and control of the federal government. This is nothing more than what now is statutorily required of contractors who wish to pledge collateral as security on a federal contract in lieu of a surety bond.

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[4] United States. Department of Justice. US Attorney's Office. Southern District of Alabama. "Pensacola Man Indicted in Government Contract Surety Bond Fraud Scheme". June 28, 2012.

[5] Richard Korman, *Controversial Individual Surety Files for Bankruptcy Protection*, ENGINEERING NEWS-RECORD, August 5, 2014 *available at*: http://enr.construction.com/business_management/finance/2014/0805-Outspoken-Individual-Surety-Files-for-Bankruptcy-Protection.asp?

If enacted, it would eliminate the gamesmanship and opportunities for fraud endemic in the current regulatory system governing individual surety bonds and pledged assets and will remove a considerable administrative burden from federal contracting officers. Federal contracting officers no longer will need to assess a range of pledged assets, as all pledged assets will be limited to assets unconditionally guaranteed by the federal government; they simply will need to gain custody over the asset to deposit the asset in a federal depository, such as the Federal Reserve Bank, St. Louis. The asset will be released upon successful performance of the bonded obligation, with any accrued interest inuring to the benefit of the individual surety pledging the government-backed asset.

Construction businesses working on a construction project—either as subcontractors, suppliers, or workers on the job—have no control over the prime contractor's choice of security provided to the federal government, but they suffer the most harm financially if the provided security proves illusory. The impact is particularly acute on small construction businesses, which may not have the strength to weather a significant disruption to their cash flow. Passage of legislation like such as H.R. 838 will mean that contracting agencies and the numerous subcontractors and suppliers on federal construction projects, in the event of a performance or payment default will know that adequate and reliable security is in place to guarantee that they will be paid for their valid claims.

Increase the Guarantee to 90% for Surety Companies in SBA Program

Background

The U.S. Small Business Administration's (SBA) Surety Bond Guarantee Program (Program) was created to ensure that small and emerging contractors who do not qualify for surety credit in the standard market have the opportunity to bid on public construction work, grow their businesses and remain a viable part of the U.S. economy. Small businesses must have access to these bonds to obtain federal construction contracts after a certain dollar threshold, and the Program assists them in obtaining these bonds.

As the Program has evolved, there are two plans under which sureties can participate in the Program. The Prior Approval Program (Plan A) was the original SBA bond guarantee program. In this Program, the surety must obtain SBA approval for each bond prior to writing the SBA guaranteed bond. The SBA maximum indemnification of the surety's loss as a result of a bond claim in Plan A is 80%, and 90% for bonds written for socially and economically disadvantaged contractors and bonds written for contracts under $100,000. The second program is the Preferred Surety Bond Program (Plan B). Under this plan, sureties apply to participate, submitting information up front on their underwriting practices and financial strength. Once a surety becomes a participant in Plan B, it is given an aggregate limit of bonds that it can write within the Program. As long as the surety complies with all of the requirements of Plan B, all bonds written within the Program qualify for reimbursement of losses. The SBA does not review or approve each individual bond before it is written and the guarantee attaches. In Plan B the surety receives a maximum 70% indemnification.

Enhancements to Program
Over the years, the Program has gone through several enhancements to increase participation and remove burdensome regulatory requirements. For example, a provision in the 2013 National Defense Authorization Act (NDAA) increased the guarantee limit from $2 million to $6.5 million to align the Program with the simplified acquisition threshold and with the needs of other SBA small business contracting programs, such as the 8a Minority Small Business and Capital Ownership Development Program. Additional reforms will provide greater enhancement opportunities for small businesses and to ensure participation from sureties.

Legislative Recommendation
NASBP and SFAA recommend amending Section 411(c)(1) of the Small Business Investment Act of 1958 (15 U.S.C. 694b(c)(1)) by increasing the guarantees afforded to surety companies that participate in the Program from 70% to 90%. This revision will likely stimulate greater corporate surety and surety bond producer participation, providing access to the corporate surety markets to small businesses which otherwise do not qualify for surety credit in the standard market. These small businesses are often the ones that may turn to unlicensed individual sureties, where they can be duped by unscrupulous persons seeking vulnerable businesses and offering surety credit to anyone, regardless of the firm's qualifications, financial wherewithal, or experience, and at rates many times higher than the filed rates charged by corporate surety markets.

No Added Cost to the Government or Risk to Taxpayers
According to the 2014 House Small Business Committee Report (REPT.113-462,Part 2, pgs.5-6) the Congressional Budget Office (CBO) "estimates that implementing this change would not have a significant effect on discretionary spending because we expect the agency would raise fees to cover any additional costs arising from the higher guarantee percentage. Enacting such legislation would not affect direct spending or revenues; therefore, pay-as-you-go procedures would not apply."

According to the SBA Office of Surety Guarantees, increased liability to the government does not seem to be a significant issue. Under the 2009 American Recovery and Reinvestment Act (ARRA), the SBA issued 218 final surety bonds for a contract value of $663 million, which resulted in only two defaults. The National Defense Authorization Act for Fiscal Year 2013 increased the eligible contract amount to $6.5 million, and up to $10 million with a Federal contracting officer's certification that the guarantee is necessary for the small business to obtain bonding. Since the increase in contract size amount, SBA has guaranteed over 170 total bonds with a contract value of over $500 million, which have resulted in no defaults.

Conclusion
NASBP and SFAA appreciate the opportunity to provide the Committee with information about the compelling need to enact legislation such as H.R. 838: (1) to protect taxpayer funds and construction businesses performing as subcontractors and suppliers on federal construction contracts and (2) to provide small businesses with greater access to regulated surety markets through the SBA Surety Bond Guarantees Program. NASBP and SFAA

hope this statement proves beneficial and welcomes any inquiries from the Committee on the points raised in this written testimony or on other matters pertinent to small businesses and surety bonding.