



INDIVIDUAL SURETIES AND MORE FRAUDULENT SCHEMES PERPETRATED

By: [Martha L. Perkins](#)

The below article is Part 2 of the article first appearing in the Fall 2014 FSLC Newsletter.

The well-known case of *Tip Top Construction v. United States*¹ involved a bid protest where the alleged low bidder sought declaratory and injunctive relief when the CO rejected its bid because it was submitted with a bid bond from an individual surety who pledged assets that did not meet FAR requirements.² The individual surety pledged “marketable coal” as the asset to back the bid bond.³ The CO considered “marketable or mined coal” as a “speculative asset” excluded by [FAR 28.203-29\(c\)\(7\)](#).⁴ Holding that personal property pledged to support an individual surety bond must be placed in an escrow account, the court entered final judgment for the government, dismissing Tip Top’s complaint.⁵

Tip Top Construction appealed to the Court of Appeals for the Federal Circuit.⁶ The appellate court affirmed the lower court’s determination, agreeing with the CO “that the proffered coal was not an acceptable bid bond asset under the FAR because coal is a speculative asset that is not readily marketable.”⁷ [FAR 28.203-2\(a\)](#) provides that the “Government will accept only cash, readily marketable assets, or irrevocable letters of credit from a federally insured financial institution”⁸ The court held that mined coal was less liquid than cash, certificates of deposit, or listed stocks and concluded that a CO “should not have to be an expert on the market for particular commodities in order to evaluate the value and liquidity of a pledged asset.”⁹

Individual surety bonds that are not secured by valuable assets or that do not provide the protection

intended by the Miller Act place taxpayers and subcontractors and suppliers at risk on federal projects. Sometimes, however, an individual surety’s Miller Act run-around scheme gets its just desserts. For instance, in *Employees’ Retirement System of the Government of the Virgin Islands v. Best Construction, Inc.*,¹⁰ an individual surety denied an obligee’s claim on a performance bond because, he asserted, the bond had expired before the bond principal’s default under the contract.¹¹ Closely reading the bond terms, the court disagreed with the surety and granted the bond obligee’s motion for summary judgment against the individual surety.¹²

The Employees’ Retirement System of the Government of the Virgin Islands (“GERS”) and Best Construction entered into a contract for construction of the GERS office building complex on St. Croix. Edmund Scarborough, acting as an individual surety, issued a bond for the project in the amount of \$4,962,480, signing an Affidavit of Individual Surety stating that an irrevocable trust receipt was held in escrow by a bank in the amount of the bond.¹³

GERS terminated the contract for Best’s failure to comply with the its terms. Scarborough denied GERS’s claim, asserting that the bond had expired before Best’s default.¹⁴ When GERS sued Best, Scarborough, and Scarborough’s company, the surety asserted, and the court held, that the bond and the trust receipt must be treated together as a single document. Section 13 of the bond stated that it was “not valid without attached

Continued on page 28

¹ No. 08-352-C, [2008 WL 3153607 \(Fed. Cl. Aug. 1, 2008\)](#).

² *Id.* at *3.

³ *Id.* at *2.

⁴ *Id.* at *3.

⁵ *Id.* at *27.

⁶ [Tip Top Constr., Inc. v. United States](#), 563 F.3d 1338 (Fed. Cir. 2009).

⁷ *Id.* at 1347.

⁸ [48 C.F.R. § 28.203-2\(a\)](#).

⁹ [Tip Top](#), 563 F.3d at 1344.

¹⁰ No. ST-08-CV-490, [2011 WL 4436290 \(V.I. Sept. 13, 2011\)](#).

¹¹ *Id.* at *1.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

INDIVIDUAL SURETIES AND...

Continued from page 9

TRUST RECEIPT.”¹⁵ The surety argued that the trust receipt was effective for seventeen months, after which it expired, and that, because the bond stated it was not valid without the trust receipt, the bond expired once the trust receipt expired.¹⁶

The court was not persuaded by the surety’s argument. The trust receipt merely stated that the bank would hold the amount in escrow for seventeen months. The court found that the trust receipt “lacks clear language specifying what would happen to the funds in the escrow account . . . seventeen months from the date the trust receipt was issued.”¹⁷ Accordingly, the court held that the bond remained in effect and that GERS was entitled to judgment as a matter of law.¹⁸

The court further noted that, even if it found that the trust receipt expired after seventeen months, such finding would not necessarily determine whether the bond itself had expired or whether Scarborough was discharged from his obligations under the bond. The court looked to the Restatement (Third) of Suretyship and Guaranty¹⁹ for the proposition that “a party’s inability to enforce the obligee’s rights against a secondary obligor’s collateral does not necessarily preclude the party from enforcing the obligee’s right against the secondary obligor itself.”²⁰

While the Miller Act is the sole remedy for unpaid subcontractors and suppliers on federal projects, sometimes an individual surety’s Miller Act payment bond will prove to provide illusory protection, as in *United States ex re. Russel Sigler, Inc. v. Associated Mechanical, Inc.*²¹ In this case, the court allowed an individual surety to expressly limit the duration of a payment bond issued pursuant to the Miller Act: “the Miller Act does not prevent a surety from setting an expiration date on a payment bond.”²²

The dispute involved an Air Force construction project for which Amerind Builders was the general contractor and subcontracted a portion of the work to Associated Mechanical. Amerind obtained a payment bond from an individual surety, E.C. Scarborough, in the amount of \$1,028,422.00. Associated Mechanical contracted with Russel Sigler to obtain heating, ventilation, and air-conditioning supplies for use in the project. Russell Sigler delivered the requested materials to the project and invoiced Associated Mechanical \$203,550.53, which Associated Mechanical refused to pay. Russell Sigler demanded that Amerind and Scarborough pay the invoice, but each refused.²³

Russell Sigler sued, and the parties filed cross-motions for summary judgment. The court began its analysis by concluding that “Sigler’s claim against Scarborough on the Bond fails because the Bond expired before Sigler performed.”²⁴ The court observed that “[t]he ultimate issue here is whether or not a surety may contractually limit the duration of a payment bond under the Miller Act.”²⁵ The parties provided no case law directly on point. The court observed that the bond in this case unambiguously terminated at the end of the project or after twelve months from the effective date, whichever occurred first.²⁶

The court further observed that the Miller Act requires government contractors to obtain performance and payment bonds approved by the contracting officer for federal projects to protect those supplying labor and materials to the project.²⁷ Russell Sigler argued that a Miller Act bond cannot be limited in duration and that allowing a surety to limit the duration of a bond to less than the actual project length would impede the Miller Act’s goal of protecting subcontractors and suppliers. The defendants argued that there is no language in the Miller Act that prevents a bond from expiring; time limitations are permitted; the bond was limited in duration; and Russell Sigler’s claims fell outside the bond’s effective period.²⁸

¹⁵ *Id.* at *2.

¹⁶ *Id.*

¹⁷ *Id.* at *3.

¹⁸ *Id.* at *6.

¹⁹ [RESTATEMENT \(THIRD\) OF SURETYSHIP AND GUARANTY § 28\(1\)\(b\) & \(c\) \(1996\)](#).

²⁰ *Employees’ Retirement System*, 2011 WL 4436290, at *4.

²¹ No. 2:09-cv-01238-RLH-GWF, 2010 WL 5100913 (D. Nev. Dec. 8, 2010).

²² *Id.* at *3.

²³ *Id.* at *1.

²⁴ *Id.* at *3.

²⁵ *Id.* at *2.

²⁶ *Id.* at *3.

²⁷ [40 U.S.C. § 3131\(b\)](#).

²⁸ *Employees’ Retirement System*, 2011 WL 4436290, at *2.

The effective date of the bond was November 16, 2007, and the bond, therefore expired no later than November 16, 2008, by its plain terms. Accordingly, the court determined that the bond terminated on November 16, 2008, twelve months later, because the project had not terminated by that date. It was undisputed that Russell Sigler performed and delivered the HVAC units in December 2008 – after the bond had expired. Therefore, the court concluded, the bond did not cover Russell Sigler’s materials. While this disconcerting result may be unusual, this case serves as a lesson to unwary bond beneficiaries that a court might allow an individual surety to limit the duration of its Miller Act bonds.²⁹

In *Russell Sigler*, the individual surety was able to perform a contractual end-run around the intended Miller Act payment protection, which came as an unpleasant shock to both the claimant and many others, because certain subcontractors and suppliers have enjoyed statutory payment protection on federal projects, as long as they asserted a claim against the payment bond within 90 days of last performing labor or furnishing materials on the project.³⁰ This case provides a sobering example of why it is critical for subcontractors and suppliers to review the payment bond, preferably prior to submitting a bid, to see just what the payment bond duration is (or is not) on a specific project. The FAR provides authority for subcontractors and suppliers and prospective subcontractors and suppliers on federal projects to request and obtain copies of payment bonds from the

contracting officer and from the prime contractor.³¹ Those subcontractors and suppliers that perform during the latter part of a project should be especially vigilant in determining whether the payment bond on a federal project has an expiration date.

IV. Battling Surety Bond Fraud

Besides seeking a copy of the payment bond on federal projects, there are a number of other steps that can be taken to combat surety bond fraud. Organizations such as NASBP, Associated General Contractors of America, and the Surety & Fidelity Association of America are combatting surety fraud through lobbying efforts and educational measures. In addition to lobbying the Maryland General Assembly to allow the individual surety law to sunset, in the federal arena NASBP and other construction and surety industry organizations are supporting legislation that requires individual sureties issuing bonds on federal contracts to secure verifiable and verified assets to back their bonds. NASBP has spearheaded an effort to garner sponsorship and support for the Security in Bonding Act of 2013, H.R. 776,³² which, among other things, would do the following:

- Require individual sureties to pledge only safe, liquidatable assets and to deposit them in the custody and control of the federal government.
- Eliminate future instances where individual surety bonds are pledged with insufficient or illusory assets.

29 See *United States ex rel. Hajoca Corp. v. Associated Mech., Inc.*, No. 2:09-cv-02087-ECR-PAL, 2011 WL 484291 (D. Nev. Feb. 7, 2011), another case in which Scarborough acted as individual surety. In this case, the court determined that the bond terminated twelve months after its effective date because the bond was expressly integrated with the certificate of pledged assets, which was valid for twelve months. But see *United States ex rel. ProBuild Co., LLC v. Edmond Scarborough*, No. 2:11cv451, 2012 WL 3257835 (E.D. Va. Aug. 8, 2012), wherein, on Scarborough’s motion for judgment on the pleadings, Scarborough again argued that an Affidavit of Individual Surety attached to a Miller Act payment bond limited the duration of the bond to one year and that the claimant’s material was furnished after the expiration of the one-year period. In denying the motion, the district court adopted the magistrate judge’s Report and Recommendation, which questioned whether the affidavit merged with the bond, as follows: “To the extent that the Miller Act contemplates that a surety’s obligation will be apparent from the terms of the contract and payment bond, and the terms of the Bond in this case do not reference the Affidavit, it would be patently unfair and contrary to the Act’s remedial purpose to read the Affidavit as limiting Scarborough’s liability.” *Id.* at *7.

30 See 40 U.S.C. § 3133(b).

31 FAR 28.106.6(d) provides the regulatory authority for subcontractors and suppliers and prospective subcontractors and suppliers to request and obtain copies of a payment bond from the contracting officer:

Upon the written or oral request of a subcontractor /supplier, or prospective subcontractor/supplier, under a contract with respect to which a payment bond has been furnished pursuant to the [Miller Act], the contracting officer shall promptly provide to the requester, either orally or in writing, as appropriate, any of the following:

- (1) Name and address of the surety or sureties on the payment bond.
- (2) Penal amount of the payment bond.

- (3) Copy of the payment bond. The contracting officer may impose reasonable fees to cover the cost of copying and providing a copy of the payment bond.

48 C.F.R. § 28.106.6(d).

In addition, FAR 52.228-12 provides authority for prospective subcontractors and suppliers to request and obtain bonds from prime contractors:

[U]pon the request of a prospective subcontractor or supplier offering to furnish labor or material for the performance of this contract for which a payment bond has been furnished the Government pursuant to the Miller Act, the contractor shall promptly provide a copy of the payment bond to the requester.

48 C.F.R. § 52.228-12.

32 H.R. 776 is currently pending in this Congress, and the individual surety portions of H.R. 776 have been placed, by amendment, in H.R. 4435, the House National Defense Authorization Act for 2015, which has passed the House. As of the date this article went to press, it is likely that the individual surety provisions in H.R. 776 will be introduced as part of a Senate procurement reform bill.

- Protect many small businesses that perform as subcontractors and suppliers on federal construction projects, knowing their payment protections are real, not illusory.

In addition to legislation to help combat surety bond fraud, NASBP has issued a one-page resource to address the critical need to educate contractors and subcontractors on how to verify the authenticity of bonds before acceptance. *Always Verify Your Bond!*³³ explains, in simple terms, how contractors, subcontractors, suppliers, and obligees can verify bonds through a two-step process, which confirms that (1) the surety is licensed in the jurisdiction of the project and (2) the bond has been authorized by that surety. Briefly, the two-step process involves:

1. Checking the authority of the surety to issue the surety bond:
 - a. Contact the state insurance department to determine if the surety is admitted in the jurisdiction of the project. The National Association of Insurance Commissioners provides a map with links to all state insurance departments.³⁴
 - b. Consult the Treasury List³⁵ to determine if a surety possesses the mandated certificate of authority to provide surety bonds on federal construction projects. The Treasury List includes the business address and phone number of each listed surety and each state in which the surety is licensed to do business.
2. Verifying that the surety actually authorized the issuance of the surety bond. Contact the surety directly to verify that the surety bond has been duly authorized. All sureties listed in the Treasury List identify a specific

contact phone number. In addition, the Surety & Fidelity Association of America publishes the SFAA Bond Obligor Guide,³⁶ which contains surety contact information for surety companies that agree to receive inquiries to verify the authenticity of surety bonds.

Conducting this two-step due diligence will help contractors, subcontractors, suppliers, and obligees avoid the significant harm caused by bonds that are unauthorized. Indeed, legitimate and reputable sureties will welcome such inquiries as they do not want to be the victims themselves of mistaken company identity and they want to protect the public perception – and reality – that bonds are a valuable product. That so many sureties volunteer to be listed in the SFAA Bond Obligor Guide and post such information conspicuously on their company websites is indicia of their significant efforts to combat surety bond fraud.

Conclusion

In this challenging economic climate, and with unscrupulous and entrepreneurial surety bond pretenders trying to game the system and cheat the government and construction industry stakeholders, it becomes more important than ever for contractors, subcontractors, suppliers, and obligees as well, to verify the authority of a surety to issue a bond, to verify that the surety authorized issuance of the bond, and, for subcontractors and suppliers, to review the terms of the bond prior to entering into contracts, if possible. Verifying that a surety has proper authority to issue a bond, that the surety has authorized issuance of the bond, and that the payment bond provides payment protection for the life of the project is nothing more than prudent risk management. ⚖️

Martha L. Perkins is general counsel of the National Association of Surety Bond Producers.

³³ NASBP, *Always Verify Your Bond!* (Jan. 2014), available at <http://www.nasbp.org> (follow “SuretyLearn.org” under “Education” and then follow “Online Resources”).

³⁴ Available at http://www.naic.org/state_web_map.htm.

³⁵ Available at http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm.

³⁶ Available at <http://www.surety.org/?page=VerifyYourBond>.