Fed Reg Changes Provide Contracting Officers New Cudgel to Threaten T-Listed Sureties

Amendments to Federal Regulations Provide Contracting Officers a New Cudgel with Which to Threaten Treasury Listed Sureties

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On October 16, 2014, the United States Department of the Treasury, Bureau of the Fiscal Service (the “Treasury”), published a Final Rule containing noteworthy revisions to 31 C.F.R. Part 223 (“Surety Companies Doing Business with the United States”) (“Part 223”). Part 223 implements 31 U.S.C. §§ 9304-08 (“Title 31”), governing sureties and reinsurers that underwrite federal surety bonds. The changes to these regulations, effective December 15, 2014, raise concerns for sureties on federal projects.

Revised Section 223.17: “Acceptance And Non-Acceptance Of Bonds”

In order for a surety to obtain a certificate to issue federal surety bonds, it must satisfy the documentary, filing, and financial requirements set forth in Title 31, as further expanded and clarified by Part 223. Moreover, 31 U.S.C. § 9304(b) requires, in part, that “[e]ach surety bond shall be approved by the official of the Government required to approve or accept the bond.” Courts had previously interpreted this provision to grant officials the discretion to refuse to accept a surety bond.[1] The Final Rule adds to Part 223 a new section, section 223.17, which explicitly recognizes that an agency may, “for cause,” decline to accept a certified surety’s bond.[2] While it may have been within an agency’s discretion to decline certain surety bonds in the past, section 223.17 threatens to systematize the use and potential misuse of such discretion.

The agency must give advance written notice that: (i) notifies the surety of the agency’s intention to decline the bond(s); (ii) sets out the agency’s reasons or cause for doing so; (iii) provides the surety with an opportunity to rebut the agency’s reasons or cause; and (iv) gives the surety an opportunity to cure the reasons or cause.[3] After the agency has considered the surety’s response, or if the surety fails to respond, the agency may decline the surety’s bonds after issuing a written determination of non-acceptance.[4]

The exact procedures and standards for this process will be agency-specific. Each agency must promulgate, by way of notice-and comment rulemaking, regulations articulating each agency’s “procedures and for cause standards for declining to accept bonds . . . .”[5] What might, therefore, be considered “for cause” reasons justifying an agency’s declination of a surety’s bonds will be established separately by each agency. The Treasury has instructed that “for cause” includes, but is not limited to, “circumstances when a surety has not paid or satisfied an administratively final bond obligation due the agency.”[6] In addition to defining additional “for cause” reasons, each agency must determine “when a bond obligation becomes administratively final under the agency’s procedures.”[7] Lastly, while each agency must provide the surety with an opportunity to rebut the agency’s reasons or cause, as well as an opportunity to cure any such reason or cause, each agency will have to decide what, exactly, these opportunities will be.[8]

Of the many concerns presented by the Final Rule, one is paramount: the new regulations appear to systematize and endorse an agency’s ability to unfairly leverage its bond claim, as a surety’s decision to contest such claim could form the basis for the declination of its bonds. Indeed, although the Treasury has instructed that “for cause” includes (but is not limited to) a surety’s failure to pay or satisfy an administratively final bond obligation, each agency will be able to promulgate both additional “for cause” reasons as well as an agency-specific definition of when a bond obligation becomes “administratively final.” This enables an agency to provide itself with “cause” for declining a surety’s bonds, even in the absence of an independent judicial determination of the surety’s bond obligations. For that matter, it also remains possible for an agency to include, as an additional “for cause” reason, the fact that a surety has not paid or satisfied another agency’s bond claim—thereby threatening the surety with loss of business on multiple fronts if it chooses to litigate what it considers to be good-faith bond defenses and is not willing to forgo asserting them.

Sureties that do business with particular agencies, and industry associations, such as the National Association of Surety Bond Producers ("NASBP"), the Surety & Fidelity Association of America ("SFAA"), and the American Insurance Association, would be prudent to play an active role and to participate or engage representatives to participate to the extent possible under each agency's rulemaking procedures.[9] Such efforts should seek, for instance, definitions of "for cause" and "administratively final" bond obligations that, taken together, may reduce the risk that a surety will face penalties for asserting good-faith defenses to bond claims. In addition, the surety's opportunity to rebut and/or cure the agency's reasons or causes should amount to more than minimal due process. At the very least, a surety should be entitled to place a deposit with the agency in order to stay the agency's declination of future bonds pending a resolution of the unpaid bond claim(s) at issue. Such deposit would either be refunded to the surety if the surety prevails or be applied towards any settlement or adverse adjudication with the agency.

If notified that an agency intends to decline its bonds, the surety's response will need to be tailored to the procedures and standards adopted by that agency. One of the few safeguards contained in the Final Rule prohibits an agency from declining an otherwise acceptable payment and performance bond if it 9 has already accepted a bid bond from the same surety for the same contract.[10]

Moreover, no agency has the authority to decline bonds if the surety obtains a judicial order staying or enjoining "the underlying obligation or other for cause reason that forms the basis for the agency's written determination to decline bonds . . . or the agency's written determination to decline bonds . . . ."[11] Therefore, in certain circumstances—particularly if the surety must protect immediate business opportunities—obtaining a preliminary injunction and/or a temporary restraining order may be necessary.

In such a case, the surety would likely have to satisfy most or all of the following factors: (a) that the surety has a reasonable chance of success on the merits of either its defenses to the bond obligation(s) underlying the agency's written determination to decline the surety's bonds, or the surety's challenge to the agency's written determination; (b) that absent the relief sought, the surety will suffer irreparable harm as a result of the agency's declination of its bonds; (c) that restraining the agency's declination of the surety's bonds is not harmful to the public interest; and (d) that the balance of hardships favors restraining the agency's declination of the surety's bonds.[12]

Of note are two decisions from the Court of International Trade, one that denied and one that granted a motion for a preliminary injunction enjoining the Customs Commissioner's rejection of surety bonds pursuant to 31 C.F.R. § 113.38 (which specifically governs customs bonds). Both decisions demonstrate that the rejection of a surety's bonds qualifies as the type of immediate harm or injury satisfying the requisite prong of the preliminary injunction standard.[13] In seeking injunctive relief, the surety should address and be prepared to demonstrate that there will be little or no negative effect upon the public interest caused by restraining an agency's ability to reject a surety's bonds when the agency deems such action to be prudent.[14]

In assessing the "public interest," the surety seeking a preliminary injunction should point out the public's interest in strong competition for federal contracts, and how an agency's inappropriate decision to blacklist a particular surety could hurt those contractors that might have difficulty obtaining alternative lines of credit in order to bid upon federal jobs. Such considerations might prove helpful in attempting to sway a court's analysis of the four-pronged standard for a preliminary injunction.

Revised Section 220.20: "Revocation proceedings initiated by Treasury upon receipt of an agency complaint"

The Treasury's Final Rule also adds to Part 223 new Sections 223.18, .19, and .20, which prescribe procedures for the revocation of a surety's certification. Revocation may occur: (i) when the Treasury determines that a surety is not in compliance with standing and financial requirements set forth in 31 U.S.C. §§ 9304-08, or (ii) when an agency submits a complaint to the Treasury seeking the revocation of a surety's certificate because the surety "has not promptly made full payment or fully satisfied one or more bond obligations naming the agency as obligee."[15]

The agency's complaint must certify that: (1) the bond obligations are "administratively final under the agency's regulations or other authorities;" (2) the surety has not paid or satisfied the bond obligations; and (3) that the surety's obligation to pay or satisfy the bond obligations has not been judicially stayed or enjoined.[16] While the agency must also submit certain supporting documentation, it does not appear that it must initially document the full merits of the claim itself.[17]

Following receipt of an agency complaint, the Treasury will notify the surety. Within twenty business days, the surety must "submit a written explanatory response," and will be "afford[ed] . . . the opportunity to address the complaint and demonstrate its qualifications to retain its certificate of authority."[18] The surety also can request an informal hearing, at which it may be represented by counsel.[19] Following a review period, the Treasury will issue a written final decision either denying the agency's complaint or revoking the surety's certificate.[20] The standard guiding the Treasury's decision is "whether the default is clear and whether the [surety's] failure to pay or satisfy the bonds is based on inadequate grounds."[21]

One of the primary concerns raised by this procedure is that by requiring the surety to respond to an agency complaint by "submit[ting] a written explanatory response" and "demonstrat[ing] its qualifications to retain its certificate of authority" and by not requiring the agency to make any initial showing as to the full merits of the claim itself, the burden of proof rests entirely with the surety. The procedures set forth in section 223.20, combined with a definition favorable to the agency of what constitutes an "administratively final" bond obligation under the agency's rules, could provide the agency with additional leverage in a dispute with a surety that asserts meritorious bond defenses.

Previously, a surety was afforded twenty business days to cure its alleged default following a Treasury decision to revoke the surety's certificate.[22] This opportunity still exists under new section 223.20 but will be denied to a surety whose non-compliance is "willful," which is defined as "careless or reckless disregard of a known legal obligation to satisfy an administratively final bond obligation."[23] Although new section 223.20(h) sets forth a list of factors to be considered in deciding whether non-compliance is "willful," this open-ended, non-conclusive list could allow the Treasury to premise a finding of "willful" noncompliance upon what a surety may consider to be its good-faith assertion of bond defenses. Therefore, sureties planning to dispute a federal bond claim must also be prepared to dispute allegations of "willful" non-compliance in order to preserve the twenty-day cure period, which could be necessary to maintain future business opportunities.

Responding to an agency complaint under the new section 223.20 will, therefore, require a considered legal strategy fitting this unique setting. It is foreseeable that a staple response may include seeking an appropriate restraining order or other similar relief, as the agency must certify in its complaint that the surety's "obligation to pay or satisfy the bond obligation has not been stayed or enjoined by a court of competent jurisdiction."[24]

Additionally, an agency's decision to decline a surety's bonds, or decision by the Treasury to revoke a surety's certificate, are ostensibly subject to judicial review as a "final agency action" under the Administrative Procedure Act ("APA").[25] This may even be the case regarding the agency's underlying "administratively final" bond determination (that would, in part, depend upon the procedures and definitions the agency adopts in the future). However, assuming such jurisdiction is available, judicial review would likely be limited to the "arbitrary and capricious" standard that has often been used to review final agency actions, including agency determinations involving the revocation of other types of certificates.[26] Therefore, the availability of judicial review under the APA might not prove adequate to allay the concerns presented by new sections 223.17 and .20.

Conclusion

The Treasury's recent Final Rule regulating the declination of a surety's bonds, as well as the revocation of a surety's ability to issue federal bonds, may be subject to misuse by aggressive agencies seeking to coerce sureties to abandon good-faith defenses to agency bond claims. Sureties and surety industry organizations would be well advised to take an active role in individual agencies' rule-making. Each agency's rules should ensure the availability of adequate procedural due process and judicial review regarding contested claims, so that sureties may cure any cause resulting in a final determination of liability before the surety faces the draconian penalty of the non-acceptance of its bonds by that agency, or worse, the loss of its ability to issue any federal bonds.

Endnotes

1 *See, e.g., Concord Cas. & Sur. Co. v. United States*, 69 F.2d 78 (2d Cir. 1934); Am. *Druggists Ins. Co., Inc. v. Bogart*, 707 F.2d 1229 (11th Cir. 1983).
2 31 C.F.R. § 223.17(b) (effective Dec. 15, 2014).
3 *Id.* at § 223.17(b)(1).
4 *Id.* at § 223.17(b)(2).
5 31 C.F.R. at § 223.17(b)(3). In certain circumstances, an agency's preexisting rules or regulations may suffice for this purpose. *See id.*
6 *Id.*
7 *Id.*
8 *See id.*
9 Indeed, in 2011, NASBP and SFAA were among several trade associations that, along with several surety companies and others, submitted comment letters to the Treasury on the proposed revisions to Part 223.
10 31 C.F.R. § 223.17(b)(5)(ii) (effective Dec. 15, 2014).
11 *Id.* at § 223.17(b)(5)(i).

12 *See Am. Motorists Ins. Co. v. Villanueva*, 706 F. Supp. 923, 926 (Ct. Int'l Trade 1989) (setting forth four-pronged standard in connection with surety's motion for preliminary injunction enjoining agency's rejection of surety's bonds pursuant to similar regulation, 19 C.F.R. § 113.38, which specifically governs customs bonds).
13 *See Old Republic Ins. Co. v. Pitman*, 520 F. Supp. 1225 (Ct. Int'l Trade 1989) (granting preliminary injunction against proposed temporary rejection of surety's bonds pursuant to 19 C.F.R. § 113.38); *American Motorists*, 706 F. Supp. at 933 ("the Court does not question that there may be some adverse business impact to plaintiff").
14 *See American Motorists*, 706 F. Supp. at 933 ("[T]he public clearly has a strong interest in ensuring that administrative procedures, which are reasonably calculated to encourage prompt payment of debt obligations to the government, remain unimpaired."). It is clear from a reading of the *American Motorists* decision, however, that, due in part to the perception that the surety had a track record of irresponsibility with respect to customs bond claims, the surety had difficulty demonstrating anything other than that it would be harmed by the rejection of its bonds. *See id.* (hardship to surety was "outweighed by the three other factors governing issuance of a preliminary injunction."). The surety might have swayed the court towards ruling in its favor had it been able to show a likelihood of success on the merits of its defenses, and also addressed the public interest in protecting unimpaired lines of credit for companies which might not be able to quickly establish a new line of credit with an different custom bond surety.
15 *Id.* at § 223.18.
16 *Id.* at § 223.20(a).
17 *See id.* at § 223.20(b).
18 *Id.* at § 223.20(c).
19 *Id.* at § 223.20(h).
20 *Id.* at § 223.20(d) and (e).
21 *Id.* at § 223.20(h). See 31 C.F.R. § 223.20(h) (effective Dec. 15, 2014).
22 *See* former 31 C.F.R. § 223.20 (to be superseded on Dec. 15, 2014).
23 *See* 31 C.F.R. § 223.20(h) (effective Dec. 15, 2014).
24 *See id.* at § 223.20(a)(3).
25 *See* 5 U.S.C. § 704 (subjecting to judicial review "final agency action for which there is no other adequate remedy in a court"). At least one surety has sought such judicial review in the past, but the only available decision from this particular case does not reveal the outcome of the litigation. *See Safety Nat'l Cas. Corp. v. U.S. Dep't of the Treasury*, No. H-07-643, 2007 WL 7238943 (S.D. Tex. Aug. 20, 2007) (surety commenced action, pursuant to APA, for review of Treasury's decision ordering surety to pay bond obligations, upon penalty of revocation of surety's certificate).
26 *See, e.g., Manin v. Nat'l Transp. Safety Bd.*, 627 F.3d 1239, 1241 (D.C. Cir. 2011) (quoting 5 U.S.C. § 706(2)(A)) (revocation of various certificates held by pilot would be upheld "unless it is 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.'").

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