



## Fidelity & Surety Law Committee

### BATTLING SURETY BOND FRAUD: WHY BOND VERIFICATION IS SO IMPORTANT

By: Martha L. Perkins

The below article is part one of a two part column appearing in the FSLC Fall and Winter editions.

#### I. Introduction

Certain events in recent years have reinforced the importance of verifying the authority of a company or an individual to issue surety bonds and verifying that the bond was authorized by the surety. During the recession and aftermath of the slow recovery, surety bond fraud and scams became a distinct feature of the construction landscape. It is an unfortunate, but verifiable, truth that there is a long and ugly history of surety bond fraud in the United States. Bond fraud can cause all kinds of unpleasant mischief on both public and private works projects: it can prevent the lowest bidder from being awarded the contract; it can leave subcontractors and suppliers without a payment remedy in the event of the principal's default; it can leave an obligee without performance recourse in the event of the principal's default; and it can undermine the public's confidence in the efficacy and responsiveness of contract surety bonds. If you have been reading *Engineering News-*

*Record* the past couple of years, then you are aware of the various fraudulent bond schemes that recently

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## BATTLING SURETY BOND...

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have been perpetuated on contractors, subcontractors, suppliers, obligees, and the public.<sup>1</sup>

The surety bond product already, at times, has a public relations issue, as there is so much misinformation and misunderstanding about what a surety bond is – and what it isn't. The contract surety industry performs unique and valuable services for owners, taxpayers, and subcontractors and suppliers through its prequalification services, guarantees of contract completion, and payment of certain subcontractors and suppliers; but there is no shortage of articles in public space that misconstrue, either through ignorance or willfulness, the nature of bid, performance, and payment bonds.

Although most contract surety bonds written are legitimate bonds, history suggests that a prudent obligee, contractor, and subcontractor should take affirmative steps to assure that the bond proffered is not fraudulent and will, in fact, provide the promised protection. Such due diligence is necessary to avoid becoming a victim of bond fraud and to protect the good name and the positive public perception of the surety product.

This article addresses the law in the United States concerning the authority of corporate sureties and individual sureties to issue bonds and, in doing so, examines selected case law involving fraudulent sureties and bonds.<sup>2</sup> In addition, this article focuses on selected advocacy efforts and educational initiatives to combat surety bond fraud, with the aim of guiding contractors, subcontractors, suppliers, and obligees on how to avoid becoming a victim of bond fraud. All construction industry stakeholders can and should combat surety fraud by taking certain delineated steps to verify the legitimacy of the surety and to ensure that the surety authorized the bond.

## II. Corporate Sureties and Fraud Perpetrated in Their Names

In the United States, almost all surety bonds are written by companies regularly engaged in the business of acting as a surety. Surety companies typically are authorized and qualified to do business by the state insurance commissioner where they are domiciled and in the jurisdiction where the bond is issued. The state departments of insurance regulate surety companies, which must meet minimum capital requirements, file periodic financial reports in those jurisdictions where they are authorized to do business, and are subject to market conduct investigations, among other regulatory requirements and actions.

Obligees, principals, and payment bond beneficiaries should always check with the state insurance commissioner to determine if the surety company is admitted to write surety bonds in the relevant jurisdiction, paying particular care to ensure that the name of the surety company is an exact match for the name of the admitted surety company. Most states maintain lists of admitted insurance companies on the website of the state insurance commissioner or will respond to phone inquiries regarding the status of licensed surety insurers.

Surety companies that wish to write Miller Act<sup>3</sup> bonds on federal construction projects must have a certificate of authority from the United States Department of the Treasury. The Treasury Department conducts a financial review of the company and sets a single bond “underwriting limitation” for the surety. The list of certified surety companies approved to write bonds on federal projects – known as Department Circular 570, the “Treasury List”, or the “T-List” – is posted on the Bureau of the Fiscal Service website.<sup>4</sup> The website includes a listing of the phone numbers of state insurance departments, which can provide further

1 See, e.g., Erin Richey, *Judge Orders IBCS and Scarborough to Return Surety Premium*, ENR NEWS-RECORD (hereinafter “ENR”) (June 2, 2014), available at [http://enr.construction.com/business\\_management/finance/2014/0602-judge-orders-ibcs-and-scarborough-to-return-contractors-premium.asp](http://enr.construction.com/business_management/finance/2014/0602-judge-orders-ibcs-and-scarborough-to-return-contractors-premium.asp); Erin Richey, *A General Contractor Upgrades from Fraudulent Surety*, ENR (Mar. 11, 2014), available at [http://enr.construction.com/business\\_management/finance/2014/0311-a-general-contractor-upgrades-from-fraudulent-surety.asp](http://enr.construction.com/business_management/finance/2014/0311-a-general-contractor-upgrades-from-fraudulent-surety.asp); Richard Korman, *New Forged Chubb Bonds Discovered, With Mounting Losses*, ENR (Nov. 4, 2013), available at [http://enr.construction.com/business\\_management/ethics\\_corruption/2013/1104-more-forged-chubb-bonds-with-mounting-losses.asp](http://enr.construction.com/business_management/ethics_corruption/2013/1104-more-forged-chubb-bonds-with-mounting-losses.asp); Erin Richey & Richard Korman, *Surety Fraud Probe Raises Questions: Who Is Melde Rutledge?* ENR (Aug. 19, 2013), available at <http://enr.construction.com/policy/legal/2013/0819-links-to-players-in-surety-fraud-drama.asp>; Richard Korman & Erin Richey, *Controversial Individual Surety Refused to Back Sub on Big New York Projects*, ENR (July 30, 2013), available at [http://enr.construction.com/business\\_management/finance/2013/0730-controversial-individual-surety-refused-to-back-claims-on-big-new-york-projects.asp](http://enr.construction.com/business_management/finance/2013/0730-controversial-individual-surety-refused-to-back-claims-on-big-new-york-projects.asp); Editorial, *Clarity Needed on Individual Surety Assets*, ENR (Mar. 4, 2013), available at <http://enr.construction.com/opinions/editorials/2013/0304-changes-needed-on-surety-assets.asp>; Richard Korman, *A Bold Individual Surety Claims His Coal-Backed Bonds are Rock Solid*, ENR (Feb. 25, 2013), available at [http://enr.construction.com/business\\_management/ethics\\_corruption/2013/0225-a-bold-individual-surety-claims-his-coal-backed-bonds-are-rock-solid.asp](http://enr.construction.com/business_management/ethics_corruption/2013/0225-a-bold-individual-surety-claims-his-coal-backed-bonds-are-rock-solid.asp).

2 The author wishes to gratefully acknowledge use of material from the fine article by Edward G. Gallagher and Mark H. McCallum, *The Importance of Surety Bond Verification*, 39:2 PUB. CONT. L.J. 269 (Winter 2010).

3 40 U.S.C. §§ 3131-34 (2006).

4 See BUREAU OF THE FISCAL SERVICE, UNITED STATES DEPT OF THE TREASURY, DEPARTMENT OF THE TREASURY'S LISTING OF CERTIFIED COMPANIES, [http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570\\_a-2.htm](http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-2.htm) (last updated July 2, 2014) (hereinafter “Treasury List”).

information about surety companies admitted in that jurisdiction.

Of course, the fact that a surety company is genuine and solvent is not enough if the bond was not authorized by that company. There have been a number of cases in which an unscrupulous party has been convicted of fraud in furnishing bonds that seemed to be, but were not, authorized by legitimate sureties. There are instances in which the supposed surety on a worthless bond had the same name as, or similar to, a well-known, reputable surety company.

For instance, in a 2014 case, *Federal Insurance Co. v. Campbell*,<sup>5</sup> a federal district court adopted the Report and Recommendation of the magistrate judge and entered a default judgment and a permanent injunction against defendants Eric Campbell, Individual Surety Group, LLC, Steve Stokeling, and First Fidelity Asurety Company, LLC.<sup>6</sup> The plaintiffs were insurance company subsidiaries of The Chubb Corporation. The complaint alleged that the defendants sold at least a dozen fraudulent surety bonds bearing the name of Chubb subsidiaries to various construction companies and collected millions of dollars in “premium.”<sup>7</sup> The Findings of Fact adopted by the district court provided, in relevant part, as follows:

Defendants created fraudulent surety bonds bearing plaintiffs’ names –insurance companies affiliated through their “common corporate parent,” the Chubb Corporation. . . . Defendants also falsely held themselves out as authorized agents or representatives of these entities and offered these forged bonds as surety for various projects throughout the United States. . . . Some of these construction projects were funded by federal, state, and local governmental entities. . . . The defendants perpetrated such a scheme in an effort to defraud construction companies throughout the United States and obtain a profit. Defendants do not have the authority to execute or issue surety bonds or policies on behalf of the plaintiffs or any other affiliate or subsidiary of The Chubb Corporation.<sup>8</sup>

The court permanently enjoined the defendants, among other things, from “[s]elling falsified surety bonds

bearing the names of Plaintiffs, or otherwise indicating that there is any commercial relationship between them and Plaintiffs . . . .”<sup>9</sup>

In another 2014 case, *Allen Engineering Contractor, Inc. v. United States*,<sup>10</sup> the Court of Federal Claims upheld the Navy’s default termination of a general contractor that had submitted fraudulent Miller Act performance and payment bonds on a project at Camp Pendleton, California. In its complaint, the plaintiff contractor alleged that the government improperly terminated the contract between the parties.<sup>11</sup> The court’s order provides a lucid discussion of the purpose of Miller Act bonds on federal projects, and the case provides an object lesson on why it is critical that contractors verify that their bonds are issued by authorized sureties and that the surety actually authorized the issuance of the bonds.

In *Allen Engineering*, after the contractor and the Navy executed the construction contract, the general contractor provided performance and payment bonds from Liberty Mutual Insurance Company. Thereafter, the contractor submitted a second set of bonds from the Individual Surety Group, which purportedly were issued by Pacific Indemnity Company (“PIC”). The Individual Surety Company represented itself as a broker for PIC, a subsidiary of The Chubb Group.<sup>12</sup>

The Navy learned from a Chubb representative that the PIC bonds were not in fact issued by PIC and were, therefore, invalid.<sup>13</sup> When the contractor was unable to obtain replacement bonds, the Navy issued a notice of termination for default. The contractor responded by filing suit in the Court of Federal Claims, which firmly rejected the contractor’s claim that the Navy violated its own regulations by accepting fraudulent bonds.<sup>14</sup> The contractor’s arguments, in essence, centered on the general theory that the Navy had violated some affirmative duty to the contractor to ensure that the bonds, submitted by the contractor, were not fraudulent.

The contractor alleged that the Navy violated several Federal Acquisition Regulation (“FAR”) provisions and Navy regulations by not properly ensuring the validity of the bonds. The court made short work of these arguments, finding that these regulations dealing with authentication or approval of bonds were

5 No. 3:13cv429/MCR/CJK, 2014 WL 1922847 (N.D. Fla. May 14, 2014).

6 *Id.* at \*1.

7 *Id.*

8 *Id.* at \*2.

9 *Id.* at \*1.

10 115 Fed. Cl. 457 (2014).

11 *Id.* at 459-60.

12 *Id.* at 460.

13 *Id.*

14 *Id.* at 461.

designed for the benefit of government employees, not private contractors. Holding that the contractor had no claim as a matter of law, the court stated the following regarding the cited Navy regulations and the purpose of Miller Act bonds:

The essential function of performance and payment bonds is to protect the government's interests and the interests of suppliers of labor and materials, respectively. See [40 U.S.C. § 3131\(b\)\(1\)](#) (stating that a "performance bond . . . [is] for the protection of the Government"); (b)(2) (stating that a "payment bond . . . [is] for the protection of all persons supplying labor and material in carrying out the work provided for in the contract"). As such, ensuring that bonds are authentic logically serves the same interests. Because this [Navy] regulation is evidently meant as a measure of protection for the Navy and for suppliers engaged by plaintiff, but not to protect the plaintiff itself, plaintiff's claim for relief . . . fails as a matter of law.<sup>15</sup>

The important lesson to be learned from *Allen Engineering* is that it is generally the responsibility of the contractor seeking surety bonds to protect itself from bond fraud. As the case illustrates, the fact that a specific surety company is genuine and solvent is not sufficient if the bond was not authorized, as in this case, by that company. It always is good practice for a contractor to contact the surety company directly and ask for confirmation that the bond was authorized. The result otherwise could be a default termination for failure to maintain valid bonds throughout the contract term.

### III. Individual Sureties and Fraudulent Schemes Perpetrated

State insurance laws require natural persons, not just companies, who wish to act as a surety on contract bid, performance, and payment bonds to obtain a license

or certificate of authority from the state insurance department.<sup>16</sup> The two exceptions to this are found in Alaska and Maryland, and the Maryland exception sunsets on September 30, 2014. The Alaska Little Miller Act provides that public works performance and payment bonds must be from "a corporate surety qualified to do business in the state, or at least two individual sureties who shall each justify in a sum equal to the amount of the bond . . . ."<sup>17</sup>

In 2014, the Maryland General Assembly wisely determined that it would allow the statute permitting individual sureties to write bonds on public works contracts without a certificate of authority from the insurance department to sunset. In 2006, the General Assembly had enacted a bill to permit individual sureties to write surety bonds under certain circumstances for prime contractors on public construction projects without obtaining a certificate of authority as an authorized insurer from the Maryland Insurance Administration ("MIA").<sup>18</sup> The law was due to terminate on September 30, 2009; and that sunset provision was extended to September 30, 2014. In Chapters 299/300, Acts of 2012, the Maryland General Assembly, among other things, required the MIA to study and report on the practices of individual and corporate sureties.

On November 25, 2013, the MIA released its *Final Report on the Analysis of the Practices of Corporate Sureties and Individual Sureties in Maryland* (the "MIA Final Report").<sup>19</sup> The substance of the MIA Final Report, along with significant lobbying efforts by the National Association of Surety Bond Producers ("NASBP")<sup>20</sup> and others, helped to defeat Maryland [2014 SB 851](#), which would have extended the 2006 law until 2019, continuing to permit an unregulated individual surety market in Maryland. Among other conclusions, the MIA Final Report included the following conclusions concerning individual sureties:

[T]he sanctioned individual sureties have engaged in fraudulent or misleading conduct, such as: (1) creating the illusion of a corporate

<sup>15</sup> *Id.* at 463.

<sup>16</sup> Most states define "insurer" to include an individual, define "insurance" to include surety bonds, and require any insurer writing insurance in the state to have a license or certificate of authority from the state insurance department. See, e.g., [FLA. STAT. ANN. § 624.02-.03, .401, .606\(1\)\(a\)](#) (West 2009); [TEX. INS. CODE ANN. § 101.002, .051\(b\)\(2\), .102](#) (Vernon 2009); [VA. CODE ANN. § 38.2-100, -121, -1024\(A\)](#) (West 2009).

<sup>17</sup> [ALASKA STAT. § 36.25.010\(A\)\(1\) & \(2\)](#) (2011).

<sup>18</sup> Chapter 299, Acts of 2006.

<sup>19</sup> Available at <http://www.mdinsurance.state.md.us/sa/docs/documents/news-center/legislative-information/corporate-sureties-and-individual-sureties-final-report-2013.pdf>.

<sup>20</sup> The NASBP is a national trade association located in Washington, DC, representing agencies employing licensed surety bond producers placing bid, performance, and payment bonds throughout the United States. The author is in-house general counsel at the NASBP, and is not a lobbyist.

form, which could mislead the public into believing that the same safeguards in place for corporate sureties exist as to the individual surety (*e.g.*, regulatory financial oversight, rate approval, and, in some cases, the backing of the state's guaranty fund); (2) inflating the valuation of property pledged; (3) pledging the same collateral for multiple projects so that the total amount of the surety bonds outstanding far exceeded the value of the collateral; or (4) misrepresenting other information as part of the surety bond submission.<sup>21</sup>

\* \* \*

In recent years, at least 13 . . . states have issued Cease and Desist Orders against individuals acting as sureties without first obtaining a certificate of authority or license. The MIA has identified no basis for continuing to permit unregulated individuals to solicit or issue surety bonds or contracts of surety insurance. The MIA recommends that the laws authorizing the use of individual sureties in the State be permitted to sunset as scheduled on September 30, 2014.<sup>22</sup>

\* \* \*

In order to better safeguard the public against the issuance of fraudulent surety bonds or contracts of surety insurance, all sureties doing business in the state should be required to obtain a certificate of authority issued by the Commissioner and should be subject to the same level of regulatory oversight required for corporate sureties under Maryland law.<sup>23</sup>

The MIA Final Report recommended that the individual surety law in Maryland should be allowed to

expire so that all sureties doing business in Maryland would be subject to the same level of scrutiny and regulation that exists under Maryland law. And so the law sunsets on September 30, 2014, leaving Alaska as the sole state permitting unregulated individual sureties to write contract bonds for state projects.

The federal government does accept bonds from individual sureties – if they place cash or cash equivalents equal to the amount of the bonds in escrow with a federally insured financial institution, or provide the government with a deed of trust on real property with sufficient equity to secure the bonds. Acceptance of Miller Act performance and payment bonds with individual sureties is governed by Part 28 of the FAR.<sup>24</sup> Under the current FAR, an individual surety can be accepted only if she or he provides a security interest in acceptable assets.<sup>25</sup> [FAR 28.203-1\(b\)](#) requires that the value of the pledged assets must be equal to or greater than the aggregate penal sums of the bonds. If the asset is real property, a recorded lien in favor of the government and proof of the value of the property must be furnished with the bond.<sup>26</sup> If the asset is anything other than real estate, it must be held in an “escrow account with a federally insured financial institution in the name of the contracting agency.”<sup>27</sup>

Unlike the evaluation of corporate sureties by the Treasury Department, there is no central entity to evaluate individual surety bonds. That evaluation falls to the contracting officer (“CO”) responsible for a particular procurement, which places a significant burden on the COs, many of whom do not have sufficient knowledge regarding surety bonds and the proper assets to back the bonds. Individual sureties are required to complete and execute an Affidavit of Individual Surety, known as Standard Form (“SF”) 28.<sup>28</sup> The sworn affidavit must include a description of the assets pledged and identify other bonds for which the assets have been pledged and any encumbrances on the assets. While the information on [SF 28](#) is intended to assist the CO in determining the acceptability of the individual surety and its assets, COs can be fooled by submissions that are not backed by real assets meeting the FAR requirements.

<sup>21</sup> *Id.* at 2.

<sup>22</sup> *Id.* at 12. In fact, at least seventeen states, to date, have issued case-and-desist orders against individual sureties: Alabama, California, Colorado, Connecticut, Florida, Georgia, Idaho, Iowa, Louisiana, Montana, Nevada, North Carolina, Oklahoma, Rhode Island, Texas, Virginia, and Washington.

<sup>23</sup> *Id.* at 26.

<sup>24</sup> See [48 C.F.R. § 28.203](#).

<sup>25</sup> *Id.* [§ 28.203-1](#).

<sup>26</sup> See *id.* [§§ 28.203-1, 28.203-2\(b\)\(4\), 28.203-3](#).

<sup>27</sup> *Id.* [§ 28.203-1\(b\)\(1\)](#).

<sup>28</sup> *Id.* § 53.228(e).

*Encon International, Inc. v. Garrahan*<sup>29</sup> illustrates the scenario of an individual surety pledging illusory real estate as collateral for Miller Act bonds. When the Environmental Protection Agency (“EPA”) awarded Encon International a nearly \$5 million contract to remediate certain lots of contaminated soil in Kansas, Encon, inexperienced with bonding, contacted Karen Barbour of The Barbour Group (“TBG”), and relied on her to help obtain the required Miller Act bonds. Through TBG’s contacts, it was determined that Linda Garrahan would serve as the individual surety on the bonds.<sup>30</sup> Garrahan executed an Affidavit of Individual Surety that identified her as the individual surety and TBG as the bond broker. The Affidavit stated that it was “made to induce the United States of America to accept [Linda Garrahan] as surety on the attached

bond,” pledging certain identified property in Nevada as a lien in favor of the EPA.<sup>31</sup> The red flag for the EPA CO should have been that Garrahan stated in a letter to the EPA that there were “unavoidable delays” in the lien filing process and that the proof of title to the United States would be forthcoming later.<sup>32</sup> The dispute arose when the defendants demanded various funds be placed in a reserve account pursuant to the indemnity agreement signed by the parties.<sup>33</sup> Readers will not be surprised to know that Garrahan did not own the Nevada property pledged as collateral to secure the bonds.<sup>34</sup> 

*Martha L. Perkins is general counsel of the National Association of Surety Bond Producers. Part two of this article will appear in the FSLC Winter 2015 newsletter edition.*

29 No. 11-2137-KGS (D. Kan. Mar. 28, 2014) (unpublished decision), available at [http://www.gpo.gov/fdsys/pkg/USCOURTS-ksd-2\\_11-cv-02137/pdf/USCOURTS-ksd-2\\_11-cv-02137-2.pdf](http://www.gpo.gov/fdsys/pkg/USCOURTS-ksd-2_11-cv-02137/pdf/USCOURTS-ksd-2_11-cv-02137-2.pdf).

30 *Id.* at 7-8.

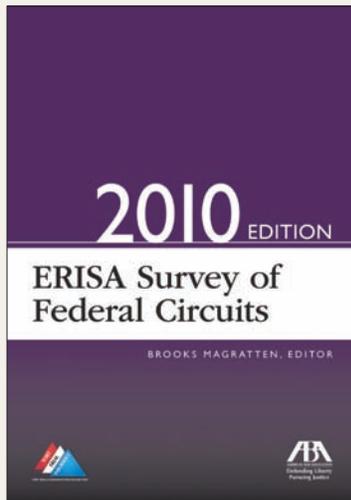
31 *Id.* at 9.

32 *Id.* at 9-10.

33 *Id.* at 11-12.

34 *Id.* at 12.

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