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Responses of Mark McCallum, CEO, NASBP, to
Questions for the Record
For the Hearing on H.R. 3534, the "Security in Bonding Act of 2011"
From Ranking Member Steve Cohen

1. What is the rationale underlying the provision in H.R. 3534 that would give discretion to contracting officers to require the use of a corporate surety and what is your response to Ms. Barbour's testimony that this provision would effectively eliminate the availability of individual surety bonds in federal contracting?

   Response: The referenced provision in H.R. 3534 was struck by amendment, and the amended bill was reported favorably by the Committee.

2. You cite the Department of the Interior Advisory Policy Release 2009-15, which notes a number of problems with contracting officers who are unfamiliar with the Federal Acquisition Regulation (FAR) requirements for individual surety and a general lack of experience in reviewing individual surety bonds.

   Why is better training for contracting officers concerning the FAR's individual surety bond requirements not a better way to address the purported problems with collateral used by individual sureties, rather than amending title 31? Should a provision addressing this concern also be included in H.R. 3534?

   Response: Adequate training of federal contracting officers is critical for a competent and efficient procurement workforce. To that end, additional training on surety bonding requirements and procedures is needed and would benefit federal contracting officers, who already are burdened with considerable administrative and procurement tasks. Such training, however, does not supplant the need for statutory changes to the types of assets that individual sureties can pledge on federal contracts. Following all the procedures correctly and ensuring collection of required documentation cannot eliminate instances where "acceptable" assets are volatile, fluctuating in value, or where such assets were pledged with misleading or mistaken documentation about valuation, such as an inflated or incorrect real estate appraisal. H.R. 3534 ensures that only the safest, most stable assets, public debt instruments guaranteed by the U.S. Government, are pledged as collateral on individual surety bonds. This is the current requirement placed on contractors who wish to pledge collateral in lieu of a corporate surety bond. Individual sureties need only convert their own assets to funds to purchase U.S. Treasury notes and other similar instruments. Their principal will be invested in one of the safest investments available and they also will accrue interest. An investment that is stable and safe for the individual surety also will be stable and safe for the contracting agency and any claimants who are unpaid and seek redress against the payment bond furnished by the individual surety.

3. You and other proponents of H.R. 3534 cite anecdotes concerning inadequate or illusory assets backing individual surety bonds. Can you provide statistics, a study, a GAO or DOJ report, or other macroscopic data that illustrate the scope of this problem beyond individual cases?

Response: NASBP is not aware of a recent government study on individual sureties. Several GAO studies were undertaken before and after the Federal Acquisition Regulation requirements governing individual sureties were amended, effective in February 1990, to address cases of individual surety fraud. Specifically, the GAO published a report in October 1989 titled, "SMALL BUSINESS: Individual Sureties Used to Support Federal Construction Contract Bonds," which provided information about individual surety use and losses and problems resulting from such use during the mid to late 1980s. The GAO gathered information about federal agency fraud investigations and bid protests involving individual sureties and summarized those findings. This information was in part a catalyst for reforms to the FAR requirements governing individual sureties. The reforms were intended to "strengthen procedures governing individual sureties," as federal officials were confronted with "widespread evidence of systematic problems" regarding methods of handling individual sureties (see *53 Federal Register 44564-01 (1988)*) and concerns that problems with individual sureties were compromising payment protections for subcontractors and small businesses providing labor and materials on federal construction projects (see report on Senate Hearing 100-384 before the Subcommittee on Federal Spending, Budget and Accounting of the Committee on Governmental Affairs, entitled *Personal Sureties Under the Miller Act: Inadequate Payment Protection for Small Business Construction Subcontractors*). Legal articles written at that time also echoed these observations and concerns (see, e.g., "Christine S. McCommas, *New Developments in Fighting Individual Surety Bond Fraud* 1990-Jan. Army Law. 56). In the background section of the proposed rule published at 53 Fed. Reg. 44564 on November 3, 1987, it is stated that "[e]xperience has shown that the information contained on the SF 28 [Affidavit of Individual Surety] is inadequate." This section continues: "[t]he frequent result is that bonds submitted by individual sureties are uncollectable to the detriment of the Government and suppliers under Government contracts." The final rule, published on November 28, 1989 at *54 Federal Register 48978,* put in place the following:

> "This final rule is issued to make revisions to the FAR procedures governing the use of individual sureties in support of a bonding requirement. Among other things, the revisions would:
> 1. Require individual sureties to pledge specific assets to support a bond.
> 2. Identify and limit the types of assets which are acceptable for pledge based upon a standard of identifiable value and ready marketability.
> 3. Require objective evidence of asset ownership and unencumbered value.
> 4. Require a Government security interest in the pledged assets by means of a lien or real property or the establishment of an escrow account for acceptable personal property.
> 5. Provide for the Governmentwide suspension or debarment of sureties who commit serious improprieties."

A second GAO study was undertaken after the FAR reforms were put in place. The study, published in April 1992 and titled "CONSTRUCTION CONTRACTS: Individual Sureties Had No Defaults on Fiscal Year 1991 Contracts," assessed individual surety use in Fiscal Year 1991. Among the conclusions of the study were the following:

> "It appears that changes to the Federal Acquisition Regulation (FAR) effective in February 1990 to curtail abuse by individual sureties were a step toward strengthening management controls over individual sureties. However, because many of the contracts in our review span several years, it would be premature to say that no problems with individual sureties will emerge."

In 1998, Michael J. Davidson, author of a thesis titled "Combatting Fraud in the Individual Surety Bond Program" written in support of requirements for a degree of Masters of Law from the George Washington University Law School, posited that the 1990 FAR reforms were inadequate to prevent instances of individual surety fraud. Situations arising from the mid-2000s to the present, in part detailed in the oral and written testimony supplied for the hearing on H.R. 3534, make clear that those changes have not been sufficient to prevent problems with individual surety bonds from continuing to occur, costing precious taxpayer funds and jeopardizing the viability of many businesses. Further information on individual surety problems can be found in "The Importance of Surety Bond Verification," by Edward G. Gallagher and Mark H. McCallum, Public Contract Law Journal, Vol. 39, No. 1 (Winter 2010). Even one unscrupulous individual surety, see e.g., George D. Black, Sr. d/b/a Infinity Surety, can be responsible for fraudulent bonds being placed on projects in multiple U.S. jurisdictions and in the tens of millions of dollars.

4. Would you support the inclusion of a GAO study requirement in H.R. 3534 to determine the scope of the problem of inadequate or non-existent assets backing individual surety bonds?

   Response: As reported in oral and written testimony at the hearing on H.R. 3534, considerable evidence of individual surety problems exists on recent federal construction projects, necessitating a response from Congress to protect taxpayer funds and subcontractors and suppliers reliant on the protections of payment bonds. NASBP would support a GAO study focused on information relating to individual surety use on federal projects.

5. Please respond to Ms. Barbour's testimony that H.R. 3534 could threaten emerging contractors, including minority- and women-owned businesses, who rely on individual sureties to obtain bonds that they could otherwise not obtain from a corporate surety given their lack of credit history or assets.

   Response: H.R. 3534 addresses the types of assets that individual sureties may pledge as collateral, requiring only use of safe investments, that is, public debt instruments guaranteed by the U.S. Government. Individual sureties having real assets should not be impacted by H.R. 3534, as such individuals need only to convert his or her existing assets to assets unconditionally guaranteed by the U.S. Government and place such assets in the safe keeping of a federal depository. The individual surety's investment principal and interest will be guaranteed by the federal government and will only be at risk if the bonded contractor defaults on its contract obligations. Such a system should not impact the availability of surety credit from legitimate individual sureties interested in serving emerging businesses, including minority- and woman-owned businesses. For these reasons, national organizations, such as the National Association of Minority Contractors, Women Construction Owners and Executives, USA, and Vet Force (Veterans Entrepreneurship Task Force), support H.R. 3534.

It is worth noting that many more small and emerging construction businesses serve as subcontractors and suppliers, rather than prime contractors, on federal construction projects. For these businesses, the integrity of the payment bond is of paramount importance. By mandating that individual sureties only pledge assets consisting of public debt instruments guaranteed by the U.S. Government, unpaid subcontractors and suppliers can rest assured that real, stable assets back their payment bond remedy and are available to pay their claims, ensuring their cash flow and the continuation of their businesses.

6. What have your members done to help emerging contractors, and particularly those that are disadvantaged business enterprises, obtain bonds so that they can bid for federal contracts, and what additional efforts do you plan to undertake in that regard?

Response: Bonding agencies, employing licensed bond producers, comprise the regular members of the National Association of Surety Bond Producers. Bond producers have a vested interest in helping businesses of all sizes to qualify for surety credit, as they only make commissions upon the issuance of a surety bond for the bonded construction firm. Bond producers work every day to position construction businesses to qualify for and to maintain surety credit. To that end, they act in many critical roles—guide, educator, adviser, and match-maker. Many NASBP bond producers work with small and disadvantaged businesses daily or weekly so they can pursue federal and other public work that requires surety bonds. Many NASBP bond producers also volunteer locally in their communities to make presentations on obtaining surety credit to local business groups, including those representing minority- and women-owned construction businesses.

As an organization, NASBP has an unparalleled commitment to bring bonding education, assistance, and awareness to all businesses seeking surety credit. NASBP, together with the Surety & Fidelity Association of America, publishes and makes available for free through the Surety Information Office web site (www.sio.org) educational pamphlets and other materials to educate small and emerging businesses on the prerequisites for surety bonding. NASBP has been and continues to participate in and support initiatives undertaken by the U.S. Department of Transportation, the U.S. Small Business Administration, and private industry organizations to educate small and disadvantaged construction businesses on ways in which to qualify for bonding. Last year, NASBP members participated in 11 U.S. DOT-sponsored bonding education and assistance workshops presented across the U.S., and NASBP members are participating in additional U.S. DOT bonding education and assistance workshops occurring in 2012. NASBP works with local jurisdictions to present bonding education programs. For example, NASBP currently is in the process of planning a one-day program on bonding education and assistance for small and disadvantaged businesses to occur in or near Baltimore, Maryland in the fall of 2012. In addition, NASBP members have participated in numerous programs conducted by the Surety & Fidelity Association of America around the country to educate and assist small and emerging contractors that have resulted in over $150 million in bonding for these contractors. These contractors now have a relationship with a surety and will be able to continue to develop and to grow.

7. Ms. Barbour suggests that individual sureties should be pre-approved like corporate sureties either by the U.S. Treasury Department or some other entity, together with an appeal process if the individual sureties if it is not included on such a pre-approved list.

   Do you agree with her suggestions? If so, should they be included in H.R. 3534?

   Response: Because the simple and common-sense statutory changes of H.R. 3534 would ensure that only safe, stable assets would be used as collateral for individual surety bonds and that such assets would be placed under the care and control of the federal government, a more elaborate, time-consuming, and expensive process such as pre-approval of individual sureties by the U.S. Department of the Treasury is not needed. Such a process, however, would be more desirable than the current situation in the absence of the statutory enhancements of H.R. 3534. It should be noted that, in the past, the U.S. Department of the Treasury has refused to become involved with individual sureties or to review them in any way. As such, the Department of the Treasury should be consulted before consideration of any legislative effort in this direction.

8. Ms. Barbour suggests that the Miller Act threshold for federal contracts requiring surety bonds should be higher than the current level in light of the fact that its original $100,000 limit was set in 1934. She suggests a $1 million threshold.

   Do you agree with her suggestions? If so, should they be included in H.R. 3534?

   Response: The original Miller Act threshold in 1935 was $2,000 (49 Stat. 793). It was increased to $25,000 in 1978 (92 Stat. 2484). The Federal Acquisition Streamlining Act of 1994 (108 Stat. 3342) increased the threshold to $100,000 and indexed it to inflation. Pursuant to the inflation adjustment, and the fact that any increase is in increments of $50,000, the threshold increased to $150,000 effective on October 1, 2010 (75 FR 53129 (8/30/2010)). The initial $2,000 threshold adjusted for inflation actually would have been $31,433 in 2010 (www.westegg.com/inflation/infl.cgi).

   Raising the bonding threshold of the Miller Act to $1 million would put at risk payment protections for countless small businesses serving as subcontractors and suppliers on federal construction projects. Subcontractors and suppliers performing federal construction work do not have mechanic's lien rights against federal property. If the prime contractor fails to pay subcontractors and suppliers due to bankruptcy or for other reasons, such subcontractors and suppliers do not have an alternative means to recover their wages, costs, and expenses—that is, they cannot place a lien against the public property and, as parties without direct privity of contract to the federal contracting agency, do not have any recourse against the federal government for payment. Especially vulnerable to nonpayment are small and disadvantaged construction businesses which operate as subcontractors or suppliers and which usually cannot afford to go unpaid on even one project. It does not make sense to jeopardize their statutory payment remedies by increasing the Miller Act bonding threshold to $1 million. Increasing the

Miller Act threshold would be a decided detriment to subcontractors, suppliers, and small and disadvantaged businesses.

Federal contracting agencies using taxpayer funds also will not have the benefit of performance guarantees on contracts less than $1 million. The federal government will retain the risk of loss on such contracts instead of shifting that risk to a knowledgeable surety in the regular business of assessing and guaranteeing performance of construction obligations. A prime contractor default or insolvency on those contracts will necessitate expenditure of additional public funding to remedy the default.