NATIONAL ASSOCATION OF SURETY BOND PRODUCERS

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Before the U.S. House of Representatives
Committee on the Judiciary
Subcommittee on Courts, Commercial and Administrative Law

In Support of

H.R. 3534
The Security in Bonding Act of 2011

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The National Association of Surety Bond Producers (NASBP) is a national trade organization of professional surety bond producers, whose membership includes firms employing licensed surety bond producers placing bid, performance, and payment bonds throughout the United States and its territories. NASBP wishes to extend its appreciation to Chairman Coble, Vice Chairman Gowdy, Ranking Member Cohen, and to the members of the Subcommittee on Courts, Commercial and Administrative Law of the U.S. House of Representatives' Committee on the Judiciary for the opportunity to provide written and oral testimony in strong support of H.R. 3534, the Security in Bonding Act of 2011.

By way of background, our testimony will begin with a brief description of the important role surety bonds play in the federal procurement arena.

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 In 1935, the Heard Act was superseded by the Miller Act, which required the continuation of these vital assurances so that U.S. taxpayer funds were protected and subcontractors and suppliers would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. Today, the Miller Act and applicable regulations require that, before any contract exceeding $150,000 is awarded for a federal construction contract, the prime contractor must furnish a performance bond and a payment bond to the contracting agency.

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.

Role of the Bond Producer

The bond producer plays a vital role in the federal construction process. The bond producer stands as the "bridge" between the construction firm and the surety company. The bond producer works closely with the construction business as an advisor, educator, and matchmaker to position the business to meet underwriting requirements in order to obtain surety credit.

The objective of the producer is not only to assist the contractor with obtaining surety credit for each contract requiring surety credit but to ensure that the contractor's business remains viable and thrives for years to come. To that end, bond producers assist construction firms of all sizes with creating networks of knowledgeable professional services providers, such as construction attorneys, certified public accountants familiar with construction business practices, and construction lenders, and may assist construction firms with market intelligence and even strategic and succession planning.

H.R. 3534 Enhances Protection of Federal Contracting Agencies, Taxpayer Funds and Construction Firms Furnishing Labor & Materials on Federal Projects

NASBP, along with ten other national construction and surety industry organizations (see attached letter to Representatives Hanna and Mulvaney), support H.R. 3534, the "Security in Bonding Act of 2011" as a critical means to protect construction businesses and to assure the integrity of surety bonds on federal contracts when issued by individuals using a pledge of assets. As noted earlier, the Federal Miller Act requires contractors to furnish surety bonds on federal construction projects to ensure 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 individual, if the bond is secured by an "acceptable asset," which includes stocks, bonds, and real property.

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 believes 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.

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 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" on February 3, 2006, still posted on the web site for the Financial Management Service at http://www.fms.treas.gov/c570/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. 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 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 will suffer financial hardship and could, in turn, default and go into bankruptcy.

Improper Individual Surety Activity

Recent situations illustrate where individual surety bond assets have 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 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. Mr. Sears eventually filed for Chapter 11 bankruptcy in the Southern District of Alabama, and it was made clear from the bankruptcy proceeding and legal depositions that most of the $126 million never existed. JBlanco Enterprises, a small business subcontractor performing work on federal contracts, nearly was forced to declare bankruptcy as a result of a deficient individual surety bond placed on a federal project that later proved to have no assets behind it.

Another notable instance surfaced in March 2010, when George Douglas Black, Sr., an individual surety doing business as Infinity Surety, was arrested and charged by the U.S. Department of Justice with mail fraud for allegedly selling more than $25 million of worthless construction bonds to 150 different construction companies on local, state, and federal public works projects, while receiving $2.9 million in fees. Among Black's alleged victims were the U.S.

Department of Navy, the Beaumont Independent School District of Texas, and the Monroe Airport in Monroe, Louisiana. It is alleged that Black repeatedly pledged the same small piece of real property to insure multi-million dollar state and federal construction contracts.

These, unfortunately, are not isolated instances. Other examples exist, both past and present, showing where individual surety bond assets proved illusory, uncollectible, or deficient. Particularly in view of the constrained economy, further instances are likely unless Congress acts to correct the requirements.

Legislative Solution

H.R. 3534, the "Security in Bonding Act of 2011," is a common-sense solution to this problem. The bill requires 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.

If enacted, H.R. 3534 will eliminate the gamesmanship inherent 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. The result of this bill is that construction businesses, the subcontractors, and suppliers on federal construction projects, will know that adequate and reliable security is in place to guarantee that they will be paid.

NASBP appreciates the opportunity to provide the Subcommittee with information about the compelling need to enact H.R. 3534 to protect taxpayer funds and construction businesses performing as subcontractors and suppliers on federal projects. NASBP would welcome any inquiries from the Subcommittee on the points raised in this written testimony.