Feature

SURETY FRAUD SCAMS

BY JAY LABE

SCAM ARTISTS HAVE long presented a challenge for the surety industry. They are lured by large premiums they can clear without the bothersome overhead of underwriting departments, claim professionals, reserves, or pesky government regulators. They skillfully prey on the construction industry with convoluted, artfully crafted documents, ingenious ruses, and promises of easy surety credit for marginal or otherwise unbondable contractors. They have come to rely on the neglect of project owners to perform any meaningful due diligence or to question myriad red flags flying throughout the documents they review.

While surety fraud is not common, it is extremely damaging to its unwitting victims. They are left helpless in its wake as they confront chaotic situations and suffer major losses with no real means of recourse.

Surety fraud also results in collateral damage to our industry. It is a threat that must be taken very seriously. It tarnishes the stellar reputation that our industry has earned over decades of providing great service and value to the construction industry.

For years the surety industry has proactively confronted threats from con artists. These efforts include extensive educational programs and perceptive lobbying activities. The goal is to make the construction industry and public less vulnerable to avoidable scams.

Although I am a Colorado-based attorney, I have seen more than my share of scammers all across the country. This article provides a glimpse of my experience with surety scams over a four-decade career in fidelity, surety, and construction claims.

The early days

In the late '70s and '80s the most common form of surety fraud I witnessed involved surety bonds that were inelegantly forged by bond principals who were refused surety credit from traditional sources. Occasionally they took it upon themselves to get the necessary bid, payment, and performance bonds by fabricating the necessary paper, using samples of legitimate powers of attorney. Unlike the perpetrators of today's more sophisticated scams, they were contractors. They wanted bonds, not premium.

These schemes unraveled almost immediately after the unsuspecting legitimate surety whose name appeared on the bond got notice of a bond claim but found no record that the bond ever existed. Public owners suddenly found themselves holding only worthless paper as protection against a failing contractor. Project suppliers were left with large receivables and no recourse to a payment bond or lien rights.

These clumsy deceptions resulted in serious but relatively localized damage. In some instances, litigation arose between a claimant and the surety company whose bond was forged. I have yet to see an instance where such a claim was successful. On occasion perpetrators were criminally prosecuted. Unfortunately, victims were generally left with large losses, worthless civil claims, and uncollectable criminal restitution awards.

When the surety industry became aware of these early instances of abuse, it took prompt action. The Surety and Fidelity Association of America, for example, created a "Bond Authentication Program." Today this program continues to provide an easy means for bond intake employees of public and private project owners to quickly

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authenticate surety bonds. It is an excellent resource when a contractor tenders a bond from an unrecognized source or shows any sign of deception.

In addition, powers of attorney used by standard sureties have become exponentially difficult to duplicate or forge as more sophisticated fraud protection technology appears on the market. Some sureties have enhanced numbering and tracking systems to better account for all powers of attorney they issue to authorized bond producers.

Individual surety scams

Contractors are required to provide "Miller Act" performance and payment bonds on most federal construction projects. With one very unfortunate exception, federal sureties must qualify as an "Acceptable Surety" on the "Treasury List," which is also known as "Circular 570." This is the U.S. Treasury Department's highly efficient means of proactively vetting the financial health and good standing of sureties in the federal market. The Treasury List is an invaluable and readily available source of current information, including the standing of each surety with its domiciliary state regulator. For decades the Treasury List has provided an effective "one-click" means of verification for federal contracting officers who bear the ultimate responsibility for assuring that Miller Act bonds come only from reputable and currently qualified sureties.

The "Individual Surety" exception to the requirement that a surety appear on the Treasury List is problematic, to say the least. It allows federal contracting officers to accept Miller Act payment and performance bonds from individuals who supply a Standard Form 28 "Affidavit of Individual Surety" but who do not appear on the Treasury List. Instead, the individual surety is only required to pledge specific collateral as security for Miller Act bond losses and make a variety of representations that cannot be easily verified. This ill-conceived exception to surety qualification requirements has given rise to serious problems with dire consequences.

The fundamental problem with the individual surety exception is that it eliminates the contracting officer's ability to use the "one-click" surety verification process afforded by the U.S. Treasury Department's Fiscal Management Service. Without this resource, a massive and unreasonable burden is placed on federal contracting officers, who have no special training in financial underwriting and no available time or resources to perform meaningful due diligence in the midst of the demands imposed by an already complex construction procurement process. Contracting officers, who are the designated surety bond intake gatekeepers, are instantly overburdened each time they are confronted by the sparsity of information the individual surety is compelled to supply in a Standard Form 28 Individual Surety Affidavit. A meaningful assessment of the integrity and financial resources of individual surety or the sufficiency and authenticity of the assets being "pledged" quickly becomes an afterthought in these difficult circumstances.

Individual surety scam artists were quick to take full advantage of this golden opportunity. They learned to count on government indifference and lack of due diligence. They clearly understood that they would be allowed to demonstrate their financial credentials with documents made from whole cloth; to describe imaginary wealth; and to use the same cookie-cutter deceptions on multiple bonds for the very same federal agency, with impunity.

The late Morris C. Sears is a prime example of systematic abuse by an individual surety, although he was nowhere near the most prolific of his kind. Sears was very good at what he did. In 2008 he formed an individual surety business known as "ABBA Bonding, Inc." I first met him on the roof that was being replaced in the course of a remodel of the U.S. Bankruptcy Court in Denver. He grudgingly appeared in connection with a Miller Act suit on a payment bond claim he flatly denied from an unpaid commercial roofing subcontractor. Ironically, unknown to Sears, the general contractor for whom Sears had issued the Miller

Act bond was once a petitioner in the very same bankruptcy courthouse where Sears was now standing on the roof. The claimant and federal agency involved were also unaware at the time that Sears was running a nationwide individual surety business out of a small office in a mobile home in Lillian, Alabama. The full scope of Sears' activities did not come to light until more of his bonds appeared on other Denver federal courthouses and he made what turned out to be an egregious error. In what Sears believed to be a stalling tactic, he sought Chapter 11 protection from the U.S. Bankruptcy Court in the Southern District of Alabama. He then found himself in the legendary "roach motel" of a Chapter 11 from which he never reappeared. He did not seem to fully anticipate the need for or understand the impact of candor in a bankruptcy setting.

The unintended side effect of his self-serving Chapter 11 petition was to bring his many victims together before a single federal bankruptcy judge whose eyes were quickly opened as she grasped the full measure of his activities in multiple jurisdictions and the state cease-and-desist orders he had ignored. Sears was ultimately confronted with criminal charges for tax evasion and bankruptcy fraud. Those charges were awaiting trial at the time of his death in 2013.

The bankruptcy proceeding revealed that Morris Sears received large premiums on the issuance of many high-value federal and state payment and performance bonds with relatively simple and entirely fictitious representations. His Standard Form 28 Affidavits in Denver pointed to a financial statement showing "ABBA Net worth of $128,195,665.61." Large and seemingly sophisticated federal procurement entities took his word. Red flags were either unseen or uniformly ignored. His repeated representations of the massive net worth of "ABBA Bonding, Inc." was somehow seen as meaningful in the face of specific instructions on the Standard Form 28 individual surety affidavit itself that prohibited business entities from acting as individual sureties.

By the conclusion of Sears' bankruptcy proceeding in Alabama, no doubt existed that his deceptions were frequent, widespread, and highly damaging. The Eleventh Circuit Court of Appeals found that, despite a federal contracting officer's approval of the bonds, Sears never had clear title to the properties in Texas, Louisiana, and Alabama that he pledged as collateral. It also determined that his representations that the real estate was unencumbered and pledged only for specific projects and bonds was deceptive. Sears' cookie-cutter SF 28 Affidavits consistently identified the same real estate. He pledged that same property time and time again on virtually all federal projects. In each case he gave the contracting officer sworn assurance that the real estate he pledged was unencumbered. Sears also had to concede that he never had a net worth of "$128,195,665.61."

It is important to appreciate that unpaid suppliers suffered devastating losses on federal projects where Sears' worthless paper had been unwittingly accepted. At the end of the day, the suppliers simply had no meaningful recourse. The procuring entities, who accepted Sears' bonds, were unsympathetic and, for all practical purposes, uncooperative. The only creditor in the Sears bankruptcy who received payment was the Internal Revenue Service.

For many years NASBP has taken a leadership role in the fight against scams. NASBP's educational programs and lobbying efforts have had a major impact on mitigating fraud and raising public awareness. Although individual sureties remain in business, NASBP's successful support of amendments to the National Defense Authorization Act of 2016 will significantly tighten controls over assets pledged by individual sureties on future federal projects.

Morris C. Sears

Our industry must remain vigilant and redouble its efforts to educate the surety bond market about the dangers con artists present. Although individual surety abuse has taken a large hit over the past few years, it is certain to morph into new and more creative schemes.

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