THE IMPORTANCE OF SURETY BOND VERIFICATION

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I. INTRODUCTION

A surety bond is a contract involving three parties in which the surety promises to answer for the debt or default of another. The party primarily liable is called the principal, and the party protected by the bond is called the obligee. On public construction projects, three types of bonds are routinely required: bid bonds, performance bonds, and payment bonds. A bid bond guarantees that if the contract is awarded to the principal, the principal will execute the contract and provide the required performance and payment bonds. The performance bond guarantees to the owner that the contract will be completed in return for payment of the contract price. The payment bond obligates the principal and surety to pay for labor and material furnished to the principal, or to a first-tier subcontractor of the principal,[1] for use in

1. In some states, the public works payment bond extends coverage beyond suppliers to first-tier subcontractors and covers persons who contracted with second-tier or lower subcontractors. *See, e.g.*, Md. Code Ann., State Fin. & Proc. § 17-108 (West 2009); Union Asphalt, Inc. v. Planet Ins. Co., 27 Cal. Rptr. 2d 371, 375 (Cal. Ct. App. 1994).

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performing the contract. Although not required by law in most jurisdictions, the prime contractor often protects against subcontractor default by requiring subcontractors to provide performance and payment bonds. Thus, the prime contractor will be the principal on the performance bond protecting the owner but the obligee on performance and payment bonds furnished by its subcontractors.

The principal is free to select the surety and pays for the bonds in the first instance, although the cost is included in the contract price and so reimbursed by the obligee. Since the bond protects the obligee, not the principal who obtains the bond, surety bonds have proven particularly vulnerable to fraud. A contractor may be willing to pay for a surety bond from an unlicensed entity without performing the diligent investigation it would use if the bond protected that contractor.

The role of a surety in the construction process is predicated on the financial standing of the surety. A surety that is not sound financially cannot add to the credit standing of its principal. Surety is regulated as a type of insurance; to some extent an obligee can depend on the state insurance departments and, for federal projects, the U.S. Department of the Treasury ("the Department" or "Treasury") to perform financial due diligence. Although the bond is normally legitimate, history suggests that a prudent owner, contractor, or subcontractor should take steps to assure that the bond actually will provide the promised protection. The time to verify that a surety is genuine is before relying on the bond either to accept a contractor or a subcontractor or to extend credit to the bond principal or its subcontractors. The bond principal should be sure the surety is genuine before paying for the bond.[2]

A long history of fraudulent bonds allows identification of certain recurring so-called red flags that should prompt further investigation. Public information is readily available on sureties, and an experienced bond producer can provide guidance on whether the available documents and information seem outside the scope of normal surety business practices and can help spot potential red flags. Performing due diligence and checking with industry professionals can avoid the disaster of relying on a bond only to find that, when a default occurs, the surety does not exist or is unable to pay its obligations. At a minimum, contractors and subcontractors should confirm that the surety is what it purports to be and is authorized to write surety insurance in the applicable jurisdiction.

2. At least three suits have been filed in the U.S. District Court for the Eastern District of Virginia by bond principals seeking to recover premiums paid to one individual surety for bonds that the obligees rejected. *See* Banneker Group, LLC v. Scarborough, No. 1:09-cv-850 (E.D. Va. filed July 30, 2009); Persaud Cos., Inc. v. IBCS Group, Inc., No. 1:09-cv-94 (E.D. Va. filed Jan. 30, 2009); Trinity Group Constr., Inc. v. Int'l Bonding & Constr. Servs., Inc., No. 1:05-cv-813 (E.D. Va. filed July 11, 2005).

II. CORPORATE SURETIES

In the United States almost all surety bonds are written by companies regularly engaged in the business of acting as a surety insurer. Surety companies typically are authorized and qualified to do business where they are domiciled and in the jurisdiction where the bond is issued. Surety companies must meet minimum capital requirements and file periodic financial reports in jurisdictions in which they are authorized to conduct business.[3] Owners, contractors, and subcontractors always should check with the state insurance commissioner to determine if the surety company is admitted to write surety bonds in the 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.

There are instances in which the purported surety on a worthless bond had a very similar name to a well-known, established surety company. For example, for several years bonds were issued in the name "International Fidelity & Surety, Ltd."[4] The U.S. Department of the Treasury consequently added the following footnote to its certified surety company listing for International Fidelity Insurance Company: "International Fidelity Insurance Company's (NAIC# 11592) name is very similar to another company that is NOT certified by this Department."[5] On April 29, 2009, the New Hampshire Insurance Department revoked the producer license of Leo M. Rush, of 25 Old Lawrence Road in Pelham, New Hampshire, and found that he had issued bonds in the name of "Eastern Shores Casualty & Indemnity Ltd." and "Continental Surety Company Ltd.," two unlicensed entities.[6] Yet, as this is written in September 2009, "Great Northern Bonding Company," also of 25 Old Lawrence Road in Pelham, New Hampshire, represents on its website that it issues performance and payment bonds.[7] Continental Insurance Company and Great Northern

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3. *See*, *e.g.*, Cal. Ins. Code §§ 700.01–.02, 900 (West 2009); N.Y. Ins. Law §§ 307, 4103 (McKinney 2009). Sureties on the Treasury List must file quarterly financial statements with the Secretary of the Treasury. 31 C.F.R. § 223.14 (2009); *see also infra* note 8 (defining the term "Treasury List").

4. States issuing cease and desist orders against International Fidelity & Surety, Ltd. include Florida and Texas. *See* Int'l Fid. & Sur., Ltd., Case No. 79842-05-CO (Fla. Office of Ins. Reg. June 3, 2005), *available at* http://www.floir.com/market_conduct/unlicensed_entities/company_orders/International_Fidelity_Surety1.pdf; Int'l Fid. & Sur., Ltd., Order No. 06-0147 (Tex. Dep't of Ins. Feb. 9, 2006). Two of the company's principal actors were indicted for fraud in relation to bonds guaranteeing payment of viatical settlement obligations. *See* Press Release, U.S. Dep't of Justice, Eight Defendants Indicted on Major Viatical/Life Settlement Fraud Scheme (Aug. 23, 2007), *available at* http://www.usdoj.gov/usao/cae/press_releases/docs/2007/08-23-07NeuhausInd.pdf.

5. Fin. Mgmt. Serv., U.S. Dep't of the Treasury, Department of the Treasury's Listing of Approved Sureties: Footnotes, http://www.fms.treas.gov/c570/footnotes.html (last updated June 30, 2009).

6. *See* Rush, Ins. No. 08-046-EP (N.H. Ins. Dep't Apr. 29, 2009), *available at* http://www.nh.gov/insurance/legal/enforcement/documents/08-046-ep.pdf.

7. *See* Great Northern Bonding Company, http://www.greatnorthernbondingcompany.com (last visited Oct. 28, 2009).

Insurance Company are both legitimate, A.M. Best-rated, Treasury-listed companies[8] that have no connection to Mr. Rush's bonds.

The use of a name very similar to that of an established insurer is one recurring red flag in connection with surety bonds. Some of these alleged surety companies maintain websites that should be carefully scrutinized for what they are saying—and what they are not saying—about the company. For example, the absence of information on the states in which a company is admitted to write surety or insurance business, its A.M. Best rating, or its Treasury certificate of authority are all warning signs.

Another red flag is if a company is incorporated in an overseas jurisdiction with lax or unknown regulatory requirements. A useful check is an Internet search on any officers identified on the website.

Surety companies wishing to write Miller Act[9] bonds on federal construction projects must possess a certificate of authority from the Treasury, which 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 ("Department Circular 570" or the "Treasury List") is posted online by the Financial Management Service, Surety Bond Branch, of the Treasury.[10]

Surety companies also are rated by private rating organizations. These third-party rating organizations compile financial information and assess financial strength and size. Rating organizations, including A.M. Best Company,[11] provide useful information in assessing the financial wherewithal of insurance companies. Rating designations vary by rating organization, so it is important to understand what each rating organization means by a particular designation.

A surety company's status as genuine and solvent is not sufficient if the bond was not authorized by that company. If an obligee has any doubt about the bond, it should contact the surety directly and ask for confirmation that the bond was authorized. Department Circular 570 includes the telephone numbers of the included sureties;[12] and the Surety & Fidelity Association of Amer-

8. *See* Fin. Mgmt. Serv., U.S. Dep't of the Treasury, Department of the Treasury's Listing of Certified Companies, http://www.fms.treas.gov/c570/c570_a-z.html (last updated Oct. 20, 2009) [hereinafter Treasury List].

9. The Miller Act generally requires performance and payment bonds on all public works contracts let by the United States if the contract amount exceeds $100,000. 40 U.S.C. §§ 3131–3134 (2006).

10. *See* Treasury List, *supra* note 8. This website also includes a listing of the phone numbers of state insurance departments, which can provide further information about surety companies admitted in those jurisdictions.

11. The A.M. Best Company of Oldwick, New Jersey, issues ratings for most U.S. insurance companies. *See* A.M. Best Company, Ratings & Analysis, http://www3.ambest.com/ratings/default.asp (last visited Oct. 28, 2009). For an explanation of its rating methodology, see A.M. Best Company, Best's Rating Center—Rating Methodology, http://www.ambest.com/ratings/methodology.asp?l=1&Menu=Rating+Methodology (last visited Oct. 28, 2009).

12. *See* Treasury List, *supra* note 8.

ica's website has a "Bond Obligee's Guide"[13] that identifies whom to contact to verify bonds issued by its members.

A recent criminal case in the U.S. District Court for the Middle District of Florida illustrates the danger of relying on merely the name of the surety. In that case, a Maryland resident, William Raymond Miller, pled guilty to mail and wire fraud in furnishing fraudulent bonds that purported to be issued by legitimate sureties.[14] The Department of Justice Press Release describing Mr. Miller's guilty plea stated: "On numerous occasions, Miller made it appear that he was issuing bonds in the names of legitimate insurers .... Miller issued surety bonds with a face value of over $535 million and received premium payments of over $22.5 million during the course of the fraud."[15] On June 18, 2009, Mr. Miller was sentenced to ten years and one month in federal prison for his surety bond-related activities.[16]

III. INDIVIDUAL OR PERSONAL SURETIES

State insurance laws require individuals,[17] not just companies, who wish to act as a surety on contract bid, performance, or payment bonds to obtain a license or certificate of authority from the state insurance department.[18] The Federal Government, however, will accept such bonds from individuals 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 bond.[19]

13. *See* Sur. & Fid. Ass'n of Am., Bond Obligee's Guide (2008), http://www.surety.org/pdf/BondObligeeGuide2008.pdf.

14. *See* Press Release, U.S. Dep't of Justice, Maryland Man Enters Guilty Pleas to $535 Million Surety Bond Fraud (Dec. 11, 2008), *available at* http://jacksonville.fbi.gov/dojpressrel/pressrel08/bond fraud121108.htm.

15. *Id.*

16. *See* Press Release, U.S. Dep't of Justice, Maryland Man Sentenced for $535 Million Surety Bond Fraud Reaching Florida and Beyond (June 18, 2009), *available at* http://www.usdoj.gov/usao/flm/pr/2009/jun /20090618_Miller_JaxFraudSent.pdf.

17. Individual sureties must be individual U.S. citizens, not partnerships, corporations, limited liability companies, or trade names. *See* FAR 53.301-28, instruction 2. For bonds on Maryland public works, "an individual surety must be a United States citizen. Corporations and partnerships cannot act as individual sureties." Md. Bd. of Pub. Works, BPW Advisory No. 2006-4, § 3 (2006), *available at* http://www.bpw.state.md.us/static_files/advisories/2006-4.pdf.

18. 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 a certificate of authority from the state's insurance department. *See, e.g.*, Fla. Stat. Ann. § 624.02–.03, .401, .606(1)(a) (West 2009); Va. Code Ann. § 38.2-100, -121, -1024(A) (West 2009); Tex. Ins. Code Ann. § 101.002, .051(b)(2), .102 (Vernon 2009).

19. *See* FAR 28.203. In the case of real property being pledged to secure the bond, potential problems that may arise include prior liens, difficulty in liquidating the property to pay bond obligations, and issues of ownership. *See, e.g.*, Mount Zion Baptist Church of L.A. v. State Farm Gen. Ins. Co., No. B206519, 2009 WL 1802779, at *3–4 (Cal. Ct. App. June 25, 2009) (describing the travails that one subcontractor endured after the Federal Government accepted an individual surety bond secured by real property).

Maryland recently passed legislation[20] to allow individuals to act as sureties on public construction contracts on terms similar to the federal requirements.[21] Both the federal and Maryland exceptions to licensure or to possessing a certificate of authority apply only if the contract bond is furnished directly to a federal agency or to a Maryland governmental unit.[22] These exceptions do not apply if the project is federally funded[23] or if the bonds are furnished by subcontractors to prime contractors on federal or Maryland public works contracts.[24]

The acceptance of Miller Act performance and payment bonds with individual sureties is governed by Federal Acquisition Regulation (FAR) Part 28.[25] Prior to amendments effective on February 26, 1990, the FAR permitted acceptance of individual sureties based on a sworn statement from each surety, verified by another party, that their net worth was sufficient to cover the bond obligations.[26] This sworn statement on then Standard Form No. 28 (SF 28), "Affidavit of Individual Surety," was often found to be false and the assets illusory or insufficient.[27] In an October 1989 re-

20. Md. Code Ann., State Fin. & Proc. § 17-104 (West 2009).

21. The Maryland Board of Public Works Advisory No. 2006-4 contains the requirements for individual surety bonds. *See* BPW Advisory No. 2006-4, *supra* note 17. Notably, Maryland requires an affidavit from the surety that he or she has not been convicted of certain crimes. *See id*. attachment B, *available at* http://www.bpw.state.md.us/static_files/advisories/2006-4B.pdf.

22. *See* FAR 28.203-1.; Md. Code Ann., State Fin. & Proc. § 17-104.

23. Brokers Procuring Individual Sureties Through a "Risk Management" Company, Op. N.Y. State Ins. Dep't Off. of Gen. Counsel (Dec. 23, 2004), http://www.ins.state.ny.us/ogco2004/rg041218.htm.

24. *See* FAR 28.203-1; Md. Code Ann., State Fin. & Proc. § 17-104.

25. *See*, *e.g*., FAR 28.203.

26. *See* FAR 28.202-2(a) (1988). The ineffectiveness of the certification requirement is illustrated by a number of cases, each of which held that the person signing the required certificate had no duty to investigate or verify the surety's claimed assets. *See*, *e.g*., Terracom v. Valley Nat'l Bank, 49 F.3d 555, 559 (9th Cir. 1995); Goldman Serv. Mech. Contracting, Inc. v. Citizens Bank & Trust Co. of Paducah, Nos. 92-5654, 92-5655, 9 F.3d 107, 1993 WL 428641, at *3 (6th Cir. Oct. 21, 1993); Beall Plumbing & Heating Co. v. First Nat'l Bank of Keystone, 847 F. Supp. 1307, 1314 (S.D. W. Va. 1994).

27. *See*, *e.g*., United States v. Bradshaw, Nos. 96-6364, 96-6508, 145 F.3d 1333, 1998 WL 279370, at *1 (6th Cir. May 20, 1998) ("The information in question materially overstated the assets of Brown and Holloway, who regularly signed the bonds as individual sureties. On occasion, moreover, the defendants fraudulently represented that the bonds were backed by corporations having substantial assets."); United States v. Upton, 91 F.3d 677, 680 (5th Cir. 1996) ("Apparently, Kinser's AIS also reflected an inflated net worth. Kinser testified that the AIS showed an inflated net worth because Barrick raised it to $5,000,000 on the AIS and then raised it again to over $7,000,000. Kinser explained that he and Barrick knew that the AIS figures were 'incorrect and fraudulent.'"); United States v. Merklinger, 16 F.3d 670, 672 (6th Cir. 1994) ("Defendant signed approximately one hundred 'Affidavit of Individual Surety' [(AIS)] forms that contained fraudulent asset figures that vastly inflated Defendant's net worth, for the purpose of inducing various government agencies to accept him as surety on government contracts . . . ."); United States v. West, 2 F.3d 66, 67–68 (4th Cir. 1993) ("The regulations have consistently required a party wishing to qualify as an individual surety to file a Standard Form 28 . . . . The charges for which Wright and West were convicted stemmed from their filing of false SF28s between 1986 and 1988."); United States v. Joseph, No. 89-10612, 921 F.2d 282, 1990 WL 212677, at *3 (9th

port,[28] the General Accounting Office ("GAO") attempted to quantify the extent of individual surety fraud prior to the 1990 FAR amendments. The GAO found:

> [F]ederal agency officials also provided us with numerous examples of cases in which individual sureties and/or contractors had submitted allegedly fraudulent information that resulted in losses to the government and/or to subcontractors and material suppliers.[29]

The *Federal Register* notice publishing the February 1990 FAR revisions for comment described the problem and the proposed solution as follows:

> Current provisions in the FAR provide that in support of each bond, an individual surety is required to submit an affidavit of individual surety (Standard Form (SF) 28) including among other things, the individual surety's assets [*sic*] liabilities, and net worth. The financial information contained on the SF 28 is to be certified as to sufficiency by any one of a number of parties. The Government is relying on the validity of the SF 28 information in the event of contractor default of its obligations.
>
> Experience has shown that the information contained on the SF 28 is inadequate. The frequent result is that bonds submitted by individual sureties are uncollectible to the detriment of the Government and suppliers under Government contracts. The Government is inadequately protected even though (for construction contracts) it generally reimburses the contractor for the premium paid for the performance and payment bonds. (See 52.232-5.)
>
> Accordingly, it has been determined that certain revisions are warranted to strengthen procedures governing individual sureties. The proposed rule would accomplish these objectives by the following revisions:
>
> 1. A bond supported by an individual surety will be accepted only with a pledge of specific assets equal to the penal amount of the bond.
>   (a) To pledge real estate, the individual surety will be required to furnish the Government with a recorded covenant . . .
>   (b) To pledge assets other than real estate, an escrow account will be required.[30]

Cir. Dec. 18, 1990) ("Campbell testified that Joseph told him, '[We] don't care if [the sureties are] bums . . . make them look like millionaires.' "); Rupert v. Dep't of Def., Civ. A. Nos. 94-1570, 94-1571, 1994 WL 495859, at *1 (E.D. La. Sept. 1, 1994) ("The Inspector General is investigating potentially fraudulent misrepresentations by individual sureties which were brokered by companies owned by the Ruperts . . . ."); Walt Rankin & Assocs., Inc. v. City of Murrieta, 101 Cal. Rptr. 2d 48, 53 (Cal. App. 2000) ("Mr. Pesnell was subsequently indicted in the United States District Court, District of Arizona, in connection with his participation in an 'Individual Surety Bonding Program.' Mr. Pesnell pled guilty to fraudulent misrepresentation."); *see also* Christine S. McCommas, *New Developments in Fighting Individual Surety Bond Fraud*, Army Law., Jan. 1990, at 56, 56 ("Bond fraud normally involves false representations by a broker or individual surety regarding the existence and availability of the pledged assets supporting the bond."); Procurement Fraud Div., Office of the Judge Advocate Gen., *Army Procurement Fraud Program—Recent Developments*, Army Law., June 1992, at 53, 55 (reporting on specific instances of false assets and certifications).

28. U.S. Gov't Accountability Office, GAO/RCED-90-28FS, Small Business: Individual Sureties Used to Support Federal Construction Contract Bonds (1989), *available at* http://archive.gao.gov/d26t7/139670.pdf.

29. *Id.* at 14.

30. Federal Acquisition Regulation (FAR); Individual Sureties; Proposed Rule, 53 Fed. Reg. 44,564 (Nov. 3, 1988).

Instead of relying on the sworn representation of the individual surety and the third party supposedly verifying the surety's financial condition, the revised FAR requires that the Government receive a lien on the surety's pledged real property or on specific assets held in an escrow account.[31] The change was comparable to a bank stopping unsecured lending based on the borrower's representations and instituting secured lending based on a security interest in specific, verified assets.

Under the amended FAR, an individual surety can be accepted only if he or she provides a security interest in acceptable assets. 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.[32] 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.[33] If the asset is anything other than real estate, it must be held in "[a]n escrow account with a federally insured financial institution in the name of the contracting agency."[34]

Unfortunately there is no central authority, such as the Treasury, to vet proposed individual surety bonds. These bonds are evaluated by the Contracting Officer ("CO") during the course of a particular procurement.[35] The CO is responsible for determining the acceptability of the individual surety and the sufficiency of pledged assets backing the bonds.[36] This places a significant administrative burden on federal COs, who otherwise will be heavily involved in the many tasks comprising the typical procurement and who possess differing levels of knowledge regarding surety bonds and the kinds of assets permitted to back surety bonds proffered by individuals.

To assist federal COs with their evaluation, individual sureties are required to complete, sign, and have notarized an affidavit of individual surety (SF 28). The affidavit must include a specific description of the assets pledged, including certified evidence of such assets, and identify other bonds for which the assets have been pledged and any encumbrances on the assets; further, the affidavit must include a sworn statement to the Federal Government concerning the validity of the information described in the affidavit.[37] COs also are required to obtain agency legal review concerning the sufficiency of the documentation pledging the surety's assets. COs are sometimes fooled, however, by artfully crafted submissions that are not backed by real assets meeting the FAR requirements. One example is *United States ex rel. Fuller v. Zoucha*, in which the U.S. District Court for the Eastern District of California stated:

31. *See* MAJ Murphy, *New Demands for Individual Sureties*, Army Law., Mar. 1990, at 40, 41 ("To pledge assets other than real estate, the assets will have to be placed in an escrow account.").

32. FAR 28.203-1(b).

33. *See* FAR 28.203-1, 28.203-2(b)(4), 28.203-3.

34. FAR 28.203-1(b)(1).

35. *See* FAR 28.200–.203.

36. *See id.*

37. *See* FAR 28.203.

> Defendant Zoucha also argues that it is impermissible for plaintiff to attach any asset other than the alleged asset pledged in the bonds executed by Zoucha, which is the 'Power of Attorney to write any Individual Surety up to $1,500,000.00 as Attorney in Fact for Polaris International, LTD.' .... Moreover, a power of attorney itself is no asset at all. It is simply a written instrument granting certain authority to an agent, often referred to as an attorney-in-fact, to act on behalf of a principal.[38]

United States ex rel. JBlanco Enterprises Inc. v. ABBA Bonding, Inc. is one of many actions against an alleged individual surety, here Morris C. Sears, and his trade name or company, ABBA Bonding.[39] In spite of a March 11, 2005, cease and desist order from the Alabama Insurance Department, Mr. Sears submitted bonds on a federal project in Colorado supported by an affidavit that ABBA Bonding had a net worth of over $126 million.[40] No assets were placed in escrow, but the General Services Administration accepted the bonds.[41] Mr. Sears eventually filed for Chapter 11 bankruptcy in the Southern District of Alabama,[42] and it was clear that most of the $126 million never existed. Nevertheless Mr. Sears apparently intended to continue writing bonds as a debtor-in-possession.[43] On July 2, 2009, the bankruptcy court converted the case to Chapter 7 and appointed a trustee to take possession of Mr. Sears's property.[44]

The U.S. Court of Federal Claims (COFC) recently discussed the FAR requirements for individual surety bonds.[45] *Tip Top Construction v. United States* involved a post-award bid protest, where the alleged low bidder, Tip Top Construction ("Tip Top"), sought declaratory and injunctive relief to void the award of a road construction contract by the Federal Highway Administration on St. John in the U.S. Virgin Islands.[46] The CO rejected Tip Top's bid because it was submitted with a bid bond from an individual surety who pledged assets that did not meet the FAR requirements.[47]

The individual surety at issue pledged "marketable coal" as the asset backing the bid bond.[48] The CO viewed "marketable or mined coal" as a "specula-

38. United States *ex rel.* Fuller v. Zoucha, No. CIV.S-05-00325-DFL-DAD, 2005 WL 2604174, at *3 (E.D. Cal. Oct. 12, 2005).

39. *See* No. 07-cv-01554-REB-CBS, 2009 WL 765875, at *1–2 (D. Colo. Mar. 20, 2009).

40. *Id.*

41. *Id.*

42. *See* Petition for Bankruptcy, *In re* Sears, No. 09-11053 (Bankr. S.D. Ala. Mar. 5, 2009).

43. *See* Sears, Case No. P-2009-120FM (Ala. Dep't Ins. May 12, 2009) (cease and desist order).

44. *See* Order and Notice of Conversion of Case from Chapter 11 to Chapter 7 of July 22, 2009, Case No. 09-11053 (Bankr. S.D. Ala. July 22, 2009); Order of July 2, 2009, Case No. 09-11053 (Bankr. S.D. Ala. July 2, 2009).

45. *See* Tip Top Constr., Inc. v. United States, No. 08-352-C, 2008 WL 3153607, at *1–27 (Fed. Cl. Aug. 1, 2008), *recons. denied*, 2008 WL 4210463 (Fed. Cl. Sept. 12, 2008).

46. *Id.* at *1.

47. *See id.* at *3.

48. *Id.* at *2.

tive asset" excluded by FAR 28.203-29(c)(7).[49] The court pointed out that the alleged asset was actually "coal refuse," but since that information was not known at the time of the CO's decision, the court did not consider it.[50]

The COFC held that personal property pledged to support an individual surety bond must be placed in an escrow account.[51] The court stated:

> Thus, the court disagrees with Tip Top's contention and finds that the solicitation and FAR provisions, when read harmoniously, are reasonably construed to require the surety to provide an asset (other than real estate) which could be placed into an escrow account.[52]

The court, therefore, entered final judgment for the Government dismissing Tip Top's complaint.[53]

The disappointed bidder appealed the COFC decision to the U.S. Court of Appeals for the Federal Circuit ("Federal Circuit").[54] It argued, among other things, that the CO did not rely on the fact that the coal could not be placed in an escrow account and, therefore, the decision could not be affirmed on that basis.[55] The Federal Circuit's opinion described the low bidder's contention:

> Tip Top's principal argument, however, is that the contracting officer did not actually reject the proffered coal on the ground that it could not be placed in an escrow account, but rather concluded that the mined coal was unacceptable because it was a speculative asset. For that reason, Tip Top asserts, the trial court improperly affirmed the agency's rejection on a ground not invoked by the agency . . . .[56]

Because the court agreed with the CO that coal is an unacceptable asset under the FAR, it found that it did not need to reach the procedural question of whether the reviewing court could reach the same result as the agency but for a different reason.[57] The court stated:

> In her February 19, 2008, letter rejecting Tip Top's bid, the [CO] stated that the mined coal proffered by Mr. Scarborough was inadequate as a bid bond asset because coal is a speculative asset and as such is unacceptable as a bid bond asset under FAR 28.203-2(c)(7). We agree with the [CO] that the pledged coal was not an acceptable bid bond asset.[58]

FAR 28.203-2(a) provides, "The Government will accept only cash, readily marketable assets, or irrevocable letters of credit from a federally insured financial institution."[59] FAR 28.203-2(b) gives examples of acceptable assets,

49. *See id.* at *3.
50. *See id.* at *13 n.3.
51. *See id.* at *22.
52. *Id.*
53. *See id.* at *27.
54. *See* Tip Top Constr., Inc. v. United States, 563 F.3d 1338 (Fed. Cir. 2009).
55. *See id.* at 1341.
56. *Id.* at 1342.
57. *See id.*
58. *Id.* at 1343.
59. FAR 28.203-2(a).

including cash, certificates of deposit, U.S. debt obligations, stocks listed on certain national exchanges, and letters of credit from a federally insured financial institution.[60] The Government argued that, because coal is personal property and is not specifically listed in FAR 28.203-2(b), it was unacceptable.[61] Tip Top responded that if the list in FAR 28.203-2(b) was exclusive, there would have been no need to give examples of unacceptable assets in subparagraph (c) of that section.[62] While rejecting Tip Top's argument, the court declined to decide whether the list of acceptable assets in FAR 28.203-2(b) was exclusive.[63]

Instead, the Federal Circuit held that, at a minimum, mined coal was unacceptable because it was clearly less like cash, stocks, or bonds and more like jewelry, furs, and antiques.[64] The court looked at the liquidity, ease of sale, and factors affecting the value of the proffered asset and ultimately concluded that the mined coal was less liquid than cash, certificates of deposit, or listed stocks.[65] According to the court, mined coal's value is difficult to attain and dependent on numerous variables such as its type, quality, and provenance.[66] The Federal Circuit finally concluded that a CO "should not have to be an expert on the market for particular commodities in order to evaluate the value and liquidity of a pledged asset."[67]

Reading the COFC and Federal Circuit *Tip Top* decisions together, a bond from an individual surety can be accepted only if the pledged assets are (1) placed in an escrow account at a federally insured financial institution subject to call by the procuring agency and (2) listed in FAR 28.203-2(b) or, at a minimum, of the same type in terms of liquidity and readily ascertainable value as the listed assets.[68]

If the individual surety actually had unencumbered assets of a sufficient value to support the bonds, compliance with FAR 28.203-2 would be simple. The individual surety could use the assets as security for an irrevocable letter of credit from a federally insured financial institution and then pledge the letter of credit to the Government. Alternatively, the assets could be invested in any number of permitted ways, including federal government bonds or stocks traded on any one of the several stock exchanges listed in FAR 28.203-2(b)(3), and the investment placed in an escrow account in the name of the procuring agency at a

60. FAR 28.203-2(b). For a list of unacceptable assets, see FAR 28.203-2(c) (including, among others, "[p]ersonal property other than that listed in paragraph (b) of this subsection (e.g., jewelry, furs, antiques)").

61. *See* Tip Top Constr., Inc. United States, 563 F.3d 1338, 1344 (Fed Cir. 2009).

62. *See id*.

63. *See id*.

64. *See id*.

65. *See id*. at 1343–44.

66. *See id*.

67. *See id*. at 1344.

68. *See id*. at 1342–44; Tip Top Constr., Inc. v. United States, No. 08-352-C, 2008 WL 3153607, at *22 (Fed. Cl. Aug. 1, 2008).

federally insured financial institution. If an individual surety does not offer acceptable assets, and instead seeks to pledge items such as "Corporate Financial Debenture Note # 2003-1, [$50 million] Hexagon Consolidated Companies of America"[69] or the coal refuse involved in the *Tip Top* cases, it suggests that the surety may not have assets that would comply with the FAR requirements.

Bonds that are not secured by valuable assets put the taxpayers at risk and also endanger subcontractors and suppliers on federal projects. The Miller Act is the sole remedy available to an unpaid subcontractor or supplier on a federal project.[70] Sovereign immunity bars any claim, legal or equitable, against the United States even if the Government's officials failed to obtain a payment bond from a solvent surety.[71] In *Brad J. Hutchinson*,[72] the comptroller general declined to refer the claims of six unpaid subcontractors to Congress pursuant to the Meritorious Claims Act.[73] After noting that the assets pledged by the individual sureties were nonexistent or otherwise unavailable to meet their bond obligations, the GAO stated:

> While it is indeed unfortunate that the claimants here are involved in a similar scenario, we do not believe that it would be appropriate for our Office to report these claims to the Congress as meritorious claims. As this case illustrates, such problems have occurred numerous times in the past and may well occur in the future. The continued referral to Congress of Miller Act bond claims such as these could create a de facto privity of contract between subcontractors and the government and result in liability on the part of the government where there currently is none.[74]

The 1990 FAR revision was an effort to ameliorate the concerns of Congress, federal procurement officials, and subcontractor organizations regarding the insufficiency of surety bonds issued by individual sureties. Individual surety bond fraud led to substantial losses for the Federal Government and for many contractors, including small and minority contractors participating as subcontractors and suppliers on federal projects.[75] Although the 1990 FAR

69. Horizon Shipbuilding, Inc., Comp. Gen. B-292992, 2003 CPD ¶ 223, at 3 (2003). The U.S. Securities and Exchange Commission successfully sued the promoters of Hexagon Consolidated Companies of America for securities fraud. *See* Litigation Release, U.S. Secs. & Exch. Comm'n, SEC Sues Officers of Hexagon Consolidated Companies of America, Inc. and Registered Assayer (Mar. 6, 2003), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20223.htm; Litigation Release, U.S. Secs. & Exch. Comm'n, SEC v. Michael J. Pietrzak (Aug. 3, 2007), *available at* http://www.sec.gov/litigation/litreleases/lr18016.htm.

70. 40 U.S.C. §§ 3131–3134 (2006).

71. *See* Dep't of the Army v. Blue Fox, Inc., 525 U.S. 255, 263–64 (1999) (holding that respondent's action to enforce a lien against the Federal Government fell outside any waiver of sovereign immunity).

72. Comp. Gen. B-230871, 96-1 CPD ¶ 282, at 4 (1996).

73. 31 U.S.C. § 3702(d) (1994).

74. *Brad J. Hutchinson*, 96-1 CPD ¶ 282, at 4.

75. McCommas, *supra* note 27, at 56 ("The task force found that information and documentation provided by individual sureties under current regulatory requirements provided inadequate protection to the government and to subcontractors, many of whom were small and minority subcontractors.").

amendment did strengthen the requirements governing individual sureties, it appears not to have eliminated opportunities for abuses on federal construction projects.[76]

IV. RECOMMENDATIONS

In the 1990 FAR amendment, the Government reacted to individual surety frauds by requiring each bond to be fully secured. In principle, that should have prevented continued fraud and abuse; but in actual practice the varying abilities of COs to understand and evaluate the alleged assets securing the surety's obligations sometimes resulted in acceptance of invalid bonds by federal contracting agencies. Experience has shown that bonds that do not comply with the FAR and are not secured by valuable assets nevertheless have been and continue to be accepted. COs should not be placed in the position of vetting individual sureties and their alleged assets on a bond-by-bond basis. In comparison, COs are not expected to evaluate the balance sheets of corporate sureties—that responsibility rests with the Treasury Department Surety Bond Branch, which has the needed expertise and performs such an evaluation before publishing Department Circular 570. All COs can and should rely on that document. A similar, centralized solution is needed for individual sureties and the supposed security for their bonds. There should be a way for the individual surety to provide the fully secured bonds contemplated by the FAR without exposing the Government and the subcontractors, suppliers, and laborers on federal projects to nonpayment.

If the Government is to continue accepting bonds based on security, the assets pledged should actually exist, meet strict standards, and be evaluated by a government agency with the necessary expertise to do so promptly and competently. Such a program already exists. Provisions within the U.S. Code allow the submission of an "eligible obligation" in place of a bond, and the Treasury Department has a program in place to evaluate and hold such eligible obligations.[77] Eligible obligations are public debt of the United States, excluding stripped components, whose principal and interest are unconditionally guaranteed by the United States.[78] The CO or other official receiving the eligible obligation would then deliver it to a custodian.[79] The custodian

76. *See*, *e.g.*, Memorandum from Rose Miller, Manager, Sur. Bond Branch, U.S. Dep't of the Treasury, to All Bond-Approving (Contracting) Officers, Important Information Regarding the Use of Individual Sureties on Federal Bonds (Feb. 3, 2006), *available at* http://fms.treas.gov/c570/special_notice.pdf; Michael J. Davidson, Combatting Fraud in the Individual Surety Bond Program (Aug. 30, 1998) (unpublished LL.M. thesis, The George Washington University Law School) (on file with The George Washington University Law School), *available at* http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA353749&Location=U2&doc=GetTRDoc.pdf.

77. 31 U.S.C. § 9303 (2006); *see* 31 C.F.R. §§ 225.3, 380 (2009).

78. U.S. Dep't of the Treasury, Acceptable Collateral for Pledging to Federal Agencies Under 31 C.F.R. Part 225 (Feb. 12, 2007), http://www.treasurydirect.gov/instit/statreg/collateral/collateral_225AcceptableCollateralUpdate2.12.07.pdf.

79. *See* 31 U.S.C. § 9303(a).

holding the eligible obligation is a federal reserve bank or such other depository institution specifically designated by the Secretary of the Treasury.[80]

If an individual surety actually has cash or cash equivalents equal to the bond amount, as is required by the existing FAR provisions, then there should be no problem using the assets to purchase government debt obligations and submitting them to the CO. The surety still would receive the interest earned on the eligible obligations,[81] but the Government could easily liquidate them in the event of a default. This procedure would end the uncertainty and litigation over what constitutes an acceptable security. The authors advocate translating an existing, proven program into the individual surety context to end fraud and abuse arising from acceptance of suspect or illusory assets—a method that would not impact the ability of a legitimate individual surety to provide Miller Act bonds.

Such a change could be accomplished by legislation or by amending the FAR. Just as the widespread fraud in the late 1980s led to the 1990 FAR amendments, it is time to address the loopholes in the application of the current FAR. Subcontractors and suppliers on federal construction projects have no recourse to assure payment for their work other than the Miller Act payment bond. Even if the Government wants to take the risk of an uncollectible performance bond, it should not force that same risk on unknowing subcontractors and suppliers who have reasonably assumed that a Miller Act bond protects their right to payment. By using the existing Treasury program to assure the value of assets pledged by individual sureties, the problem of fraudulent individual surety bonds can be eliminated.

At the same time, the FAR should be amended to add more transparency to the process so that potential subcontractors and suppliers would be able to find out if a federal contracting agency accepts anything less than a 100% payment bond issued by a surety included in Department Circular 570. The information could be made available electronically, or the contractor could be obligated to provide such information to prospective subcontractors and suppliers.

V. CONCLUSION

On any construction project, a subcontractor or supplier considering extending credit in reliance on a payment bond should obtain a copy of the bond before agreeing to extend the credit. If the bond is not from a known surety, the supplier or subcontractor should perform its due diligence. It should verify that the surety is an admitted insurer in the state involved—most states maintain lists of admitted insurance companies on the website of the state insurance department—and, for federal projects, that the corporate surety is on

80. 31 C.F.R. § 225.2.
81. 31 C.F.R. § 225.6.

the U.S. Department of the Treasury List of sureties acceptable to the United States. If the supplier or subcontractor is not confident in the bond, it should verify that the bond was authorized by the surety. If an obligee has required a surety bond, whether of its own initiative or to meet a legal obligation, it should verify that the surety meets all applicable legal requirements including a certificate of authority from the state insurance department.

On a federal or Maryland public contract, if the surety is an individual instead of a regulated insurer, anyone relying on the bond should verify with the designated financial institution that it is holding cash or cash equivalents in an escrow account in the name of the contracting agency for use in meeting the surety's promises. If the alleged financial institution cannot be located, or is not a federally insured bank, anyone relying on the bond should check on any criminal record, bankruptcies, or cease and desist orders issued against the purported surety or the alleged financial institution.[82]

There is a long, unfortunate history of fraud in connection with surety bonds. Anyone can avoid becoming the victim of such a fraud, however, by taking steps to verify the legitimacy of the surety and that it authorized the bond. The amendments suggested in this article would be one solution to the continuing problem of unsecured individual surety bonds.

82. Further information about surety bonds can be obtained by visiting the following websites: *see* National Association of Surety Bond Producers, http://www.nasbp.org (last visited Oct. 28, 2009); Surety & Fidelity Association of America, http://www.surety.org (last visited Oct. 28, 2009); and Surety Information Office, http://www.sio.org (last visited Oct. 28, 2009).