

GAO

United States General Accounting Office  
Fact Sheet for Congressional  
Requesters

October 1989

# SMALL BUSINESS

## Individual Sureties Used to Support Federal Construction Contract Bonds



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046651/139670



United States  
General Accounting Office  
Washington, D.C. 20548

Resources, Community, and  
Economic Development Division

B-235444

October 3, 1989

The Honorable Dale L. Bumpers  
Chairman, Committee on Small Business  
United States Senate

The Honorable John J. LaFalce  
Chairman, Committee on Small Business  
House of Representatives

The October 3, 1988, conference report on the Small Business Administration Reauthorization and Amendment Act of 1988 directed the General Accounting Office to conduct a review of surety bonds that would address three separate matters. Concerns had been raised that a proposed revision to the Federal Acquisition Regulation could severely restrict the availability of individual sureties. Information on the proposed revision including comments from interested parties is provided in section 5 of this fact sheet. Because of the need for information on individual sureties, it was agreed with your offices that we would concentrate our initial review efforts in that area. Specifically, we agreed to provide information on (1) the extent to which individual sureties are used, (2) the amount of losses that have resulted from their use, and (3) the bid protest decisions that GAO has issued that involve individual sureties.

The conference report also directed GAO to review (1) the bonding needs of small and small, disadvantaged business concerns and (2) potential limitations in protection accorded to subcontractors and material suppliers by the Miller Act. We will address these concerns in a subsequent report.

The Miller Act of 1935, as amended (40 U.S.C. 270a-270f), requires two types of bonds on federal construction contracts exceeding \$25,000: (1) performance bonds, which are intended to protect the government in case the contractor defaults and (2) payment bonds, which are intended to ensure that subcontractors and material suppliers are paid for labor and materials provided. Two types of sureties--corporate and individual--are accepted as meeting the Miller Act bonding requirement. A corporate surety is generally a corporation that is licensed under various insurance laws and, under its charter, has legal power to act as a surety for others.

Annually, the Department of the Treasury publishes a list of companies that it has approved to issue corporate sureties. An individual surety is a person, as distinguished from a business entity, who is liable for the amount of the bond obligation. Individual sureties allow contractors that are unable to obtain corporate sureties to obtain the bonding necessary to bid on federal construction contracts. However, unlike corporate sureties, individual sureties are not reviewed and approved by the Department of the Treasury; they are approved directly by the federal agencies' contracting officers. The statutory authority to use individual sureties is found in 31 U.S.C. 9304(b) (1982).

In summary, we found the following:

- Aggregate data do not exist on either individual surety usage or losses because federal agencies that contract for much of the government's construction, and associations that represent construction contractors and bond providers, do not routinely collect such data. However, as documented in the following sections, we were able to develop limited information on both the extent to which individual sureties are used and the types of losses that can result from their use.
- GAO bid protest decisions involving individual sureties have increased sharply in the last 2 years, from 6 in 1987 to 21 in 1988 and 23 in the first 6 months of 1989.

#### EXTENT TO WHICH INDIVIDUAL SURETIES ARE USED

Even though none of the federal agencies we contacted required their contracting offices to routinely compile data on surety bonds, we did obtain limited information from several agencies. The following two examples describe the types of information obtained:

- Ad hoc studies conducted by the Department of Veterans Affairs (VA) and General Services Administration (GSA) showed that in fiscal year 1988, VA awarded 38 of its 865 small business construction contracts to firms using individual sureties; and GSA awarded 27 of its 635 construction contracts with small businesses to firms using individual sureties.
- Two companies that arrange for individual sureties for contractors needing bonds have provided information on the

amount of bonds that they have arranged. One company reported that it had supplied individual sureties used to support bonds on over \$400 million in government construction contracts over a 3-year period. An official of a second company said that his company provided individual sureties for bonds amounting to \$56.8 million in 1988.

LOSSES AND PROBLEMS RESULTING FROM  
THE USE OF INDIVIDUAL SURETIES

Although aggregate data are not available, we did obtain information from several sources that describes the type of losses that can be attributed to the use of individual sureties. This information indicates that such losses vary depending on when the problems with the individual sureties are identified and whether or not the contractor performing the work defaults. For example, if an agency rejects the individual sureties before the contractor starts work on a project, losses consist primarily of (1) the staff time and expense of investigating the individual sureties and re-awarding the contract and (2) the delay incurred in starting work on the project. If the problem with the individual sureties is not detected until the work on the project is complete or nearly complete and the contractor performed satisfactorily, the only added cost to the federal agency is the amount the contractor was reimbursed for worthless bonds. However, when a contractor defaults on a partially completed project and the sureties prove to be worthless, the agency has to pay another contractor to complete the project. Further, subcontractors and material suppliers may not be paid for labor and materials provided to the defaulted contractor.

One indicator of the extent of the problems federal agencies have experienced with individual sureties is the number of investigations that have been undertaken involving individual sureties. The Department of the Interior's Office of Inspector General obtained information from 15 federal agency investigative units in June and July 1988 that showed 10 of these units were conducting a total of 45 investigations of alleged fraudulent activity involving individual sureties. Some individual sureties are involved in more than one investigation, and some of the investigations involve more than one federal contract. In addition, although Department of the Army did not respond to Interior's request for data, officials of the Army's Criminal Investigation Command told us that the Command had about 50 investigations of individual sureties open as of July 1989.

BID PROTESTS INVOLVING INDIVIDUAL SURETIES

GAO bid protest decisions issued between January 1, 1985, and June 30, 1989, showed that the number of decisions involving individual sureties has increased sharply in the last 2 years--from 6 in 1987 to 21 in 1988 and 23 in the first 6 months of 1989. The two most common issues involved in the protest decisions were (1) the surety's duty to disclose all outstanding bond obligations and (2) the surety's financial ability to satisfy its bond obligations.

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This fact sheet is divided into five sections that discuss (1) background information on the legislative and regulatory provisions that cover surety bonding requirements and the scope and methodology of our review; (2) data on the number and dollar amount of federal contracts with bonds supported by individual sureties; (3) information on losses and other problems associated with the use of individual sureties; (4) bid protest decisions issued by GAO since January 1, 1985, that involved individual sureties and the procedures GAO uses to evaluate bid protests; and (5) proposed changes to the Federal Acquisition Regulation that relate to individual sureties.

We discussed the factual information presented in this fact sheet with officials from GSA and the Departments of the Interior, Veterans Affairs, Defense, Army, Navy, and Air Force and incorporated their comments where appropriate. At your request, we plan no further distribution of this fact sheet until 30 days from the date of this letter. At that time, we will provide copies to the entities listed in appendix I and make copies available to others upon request.

B-235444

Major contributors to this fact sheet are listed in appendix V. If you have any questions concerning the matters discussed, please contact me at (202) 275-5525.

A handwritten signature in cursive script that reads "John M. Ols, Jr.".

John M. Ols, Jr.  
Director, Housing and  
Community Development Issues

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4.1	Number of Individual Surety Bid Protests Decided by GAO (Jan. 1, 1985, Through June 30, 1989)	24
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## ABBREVIATIONS

FAR	Federal Acquisition Regulation
GAO	General Accounting Office
GSA	General Services Administration
OIG	Office of Inspector General
SF	standard form
VA	Department of Veterans Affairs
VAMC	VA Medical Center



## SECTION 1

### BACKGROUND

#### LEGISLATIVE REQUIREMENTS

The Miller Act of 1935 (40 U.S.C. 270a-270f) requires contractors on federal construction contracts exceeding \$25,000 to post two types of bonds: performance bonds and payment bonds. The principal purpose of the performance bond is to protect the government. The performance bond ensures that if the contractor does not complete the work, the government will receive a penal amount of up to 100 percent of the contract price from the provider of the bond. The principal purpose of the payment bond is to protect subcontractors, material suppliers, and employees. The payment bond is intended as a guarantee that subcontractors, suppliers, and employees will be paid for work performed and/or material provided on the contract.

Although Miller Act bonding requirements apply only to federal contracts, most states and many local governments have what are referred to as "little Miller Acts." These acts also require bonding of construction contracts; however, the minimum contract amount at which these provisions apply varies from state to state, and some states reportedly will not accept individual sureties.

#### REGULATORY REQUIREMENTS

Federal Acquisition Regulation (FAR) Part 28, which implements the Miller Act, requires Miller Act contractors to post bid bonds. This is in addition to the performance bonds and payment bonds required by the act. Bid bonds ensure that the bidder will not withdraw a bid within the time period specified for acceptance and will execute a written contract and furnish required bonds within the time period specified in the bid.

The FAR provides that acceptable forms of surety include corporate and individual sureties, U.S. bonds or notes, bank drafts, and cash or cashier's checks. The FAR defines an individual surety as one person, as distinguished from a business entity, who is liable for the entire penal amount of the bond. It also requires that at least two individual sureties execute the bond and that the net worth of each individual must equal or exceed the penal amount of the bond.

Current provisions of FAR require each individual surety to execute a Standard Form 28, Affidavit of Individual Surety. The affidavit includes information on the surety's assets and liabilities; according to FAR, the information provided is helpful in determining the net worth of proposed sureties. However, the only other guidance FAR currently provides for accepting individual sureties is:

"Contracting officers shall consider the number and amounts of other bonds upon which a proposed individual surety is bound, and the status of the contracts for which such bonds were furnished, in determining the acceptability of the individual surety."

The General Services Administration (GSA) is the only federal agency we are aware of that has supplemented the FAR provision on individual sureties in its agency regulations. In the early 1980s, GSA encountered problems with the use of individual sureties. As a result, in 1983 GSA issued an internal supplement to the Federal Procurement Regulations, the predecessor regulation to the FAR, that allows its contracting officers to establish a security interest in the surety's assets. This is accomplished by requiring the sureties to provide a recordable covenant not to convey or encumber real estate and/or to place commercial or government securities in escrow accounts. Such a requirement is meant to ensure that the surety has and retains adequate assets to support the bond.

#### CONTRACTS SUBJECT TO THE MILLER ACT'S BONDING REQUIREMENTS

On July 18, 1989, we obtained data from the Federal Procurement Data Center on the number and dollar amount of federal construction contracts awarded during fiscal year 1988 that exceeded \$25,000. According to these data, 15,120 federal contracts were awarded; the total amount of these contracts, including any contract modifications, was \$8.6 billion. The six federal agencies with the largest volumes of construction contracting activity are shown in table 1.1.

Table 1.1: Number and Dollar Amount of Construction Contracts  
Awarded in Fiscal Year 1988

Dollars in thousands

<u>Department/agency</u>	<u>Construction contracts</u>	
	<u>Number</u>	<u>Amount</u>
Department of the Army	4,856	\$3,412,391
Department of the Navy	2,953	2,185,335
Department of the Air Force	2,606	854,205
Department of Veterans Affairs	977	633,945
Forest Service	854	252,296
General Services Administration	510	240,832
Other federal agencies	<u>2,364</u>	<u>1,049,488</u>
Total	<u>15,120</u>	<u>\$8,628,492</u>

#### SCOPE AND METHODOLOGY

To develop the information in this fact sheet, we interviewed and obtained information on individual surety usage and problems experienced from officials in the headquarters

offices of various federal departments and agencies, and associations representing construction contractors and surety bond providers. (See app. I for a list of the federal government and private sector entities contacted.) We also reviewed and analyzed documents maintained by the Task Force on Individual Sureties, an interagency task force established by the Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council. The task force has studied individual sureties and drafted proposed revisions to the FAR provision that covers individual sureties. The documents we reviewed included public comments submitted in response to the proposed revisions. We conducted our review between March and July 1989 in accordance with generally accepted government auditing standards.

## SECTION 2

### NUMBER AND DOLLAR AMOUNT OF FEDERAL CONTRACTS

#### WITH BONDS SUPPORTED BY INDIVIDUAL SURETIES

Federal agency officials told us that the use of individual sureties has increased sharply in the last 2 to 3 years, but none knew the extent to which individual sureties are used nationwide. They stated that no one (i.e., federal agencies or private industry) routinely collects data on the number or dollar value of federal contracts with bonds supported by individual sureties. However, two federal agencies we contacted have made ad hoc requests for such data from their contracting offices for specified time periods. In addition, two firms that provide individual sureties to construction contractors have reported information on the volume of individual sureties that they have handled in recent years.

#### FEDERAL AGENCY DATA

Surety bond data are maintained at the federal agencies' individual contracting offices, but none of the agencies we contacted require their contracting offices to routinely compile data on surety bonds. The Chairman of the Task Force on Individual Sureties, a task force with representatives from eight federal agencies, said that the task force had not identified any federal agency that routinely compiles data on the extent to which individual sureties are used. Similarly, an official in the Small Business Administration's Office of the Chief Counsel for Advocacy said that when he inquired about the availability of such data when conducting the Initial Regulatory Flexibility Analysis on the proposed rule on individual sureties, he was also told that no universal data exist on the extent to which individual sureties are used. However, the Department of Veterans Affairs (VA) and the GSA have made ad hoc requests of their contracting offices for information on individual sureties.

In August 1988 the VA's Office of Acquisition and Materiel Management asked VA field offices to submit information on contracts for which individual sureties were used on bid, payment, or performance bonds. The data were to cover any open contracts (including warranty period), regardless of when they were awarded, and any closed-out contracts awarded after October 1, 1986. Data reported by the contracting offices showed that during fiscal year 1987, 13 (1.5 percent) of their sealed-bid and competitively negotiated small business construction contracts and 25 (13.5 percent) of their small, disadvantaged business construction contracts were awarded to firms using individual sureties. During fiscal year 1988, the figures were 17 (2.4 percent) and 21 (13.1 percent), respectively. No large business firms used individual sureties during fiscal years 1987 and 1988. (See app. II for detailed information on VA contracts

awarded during fiscal years 1987 and 1988 that were subject to the Miller Act bonding requirements.)

In February 1989 GSA's Office Of Acquisition Policy asked GSA regional contracting offices for similar information on contracts awarded during fiscal year 1988. The contracting offices reported that they had awarded 674 contracts subject to the Miller Act--28 to small, disadvantaged businesses, 607 to other small businesses, and 39 to larger businesses. Twenty seven (4.3 percent) of the 635 contracts with small businesses used individual sureties. However, none of the contracts with the small, disadvantaged businesses or large business firms used individual sureties. (See app. III for detailed information on these GSA contracts.)

One federal agency, the U.S. Army, requires its contracting offices to forward documentation on all surety bonds to a central office for review and approval. However, this office, which just recently obtained a computer, had never attempted to compile any data on individual surety usage. The head of the office said that it receives documentation on about 10,000 bonds (5,000 performance and 5,000 payment) each year, but she had no idea how many of the bonds were being supported by individual sureties. She said that her office received very few individual sureties before late summer 1987 but since that time has received quite a few.

On June 29, 1989, the Assistant Counsel for Procurement in the Office of Chief Counsel, U.S. Army Corps of Engineers, told us the Corps was testing a computer system that will enable district offices to input data on all individual sureties submitted by contractors on Corps procurements. He said that Corps contracting offices will use the system to determine if proffered individual sureties have been accepted and/or rejected on other Corps contracts and, if rejected, why they were rejected. A computer system analyst for the Corps estimated that, by the end of 1989, district offices will be using the database regularly.

#### PRIVATE INDUSTRY DATA

Unlike corporate surety providers, individual sureties do not have associations that represent them. As a result, there is no focal point in the private sector for collecting nationwide data on individual sureties. However, we were able to obtain some information from the private sector on the extent to which individual sureties are being used. For example, the Executive Director of the National Association of Minority Contractors estimated that individual sureties are used on federal contracts valued at about \$800 million annually.

In commenting on the proposed rule on individual sureties, officials of one company that provides individual sureties to construction contractors said that the company had bonded over

\$400 million in government construction contracts over a 3-year period.

A second company testified on February 22, 1989, before the Government Activities and Transportation Subcommittee of the House Committee on Government Operations on the proposed rule on individual sureties. According to the company's prepared statement, the company provided individual sureties for 158 payment/performance bonds valued at \$56.8 million in 1988.

### SECTION 3

#### LOSSES AND PROBLEMS

##### ASSOCIATED WITH INDIVIDUAL SURETIES

Federal efforts to gather governmentwide or agencywide data on losses or problems resulting from the use of individual sureties have been limited to (1) compilations of data on investigations of individual sureties by federal investigative offices and (2) ad hoc studies of individual sureties conducted by VA and GSA. (See sec. 2.) However, federal 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.

The data we gathered showed that the use of individual sureties can result in different types of adverse effects. Some of these effects are readily quantifiable, but others are not. For example, when a contractor defaults and the individual sureties do not fulfill their responsibilities, it is possible to determine the dollar amounts that the (1) contractor owes subcontractors and material suppliers for labor and materials provided to the project, (2) agency reimbursed the contractor for bonds (amount paid for individual sureties), and (3) agency paid another contractor to complete the project. However, other adverse effects associated with individual sureties are not easily quantified. These include costs associated with delays in starting and/or completing the project and agency staff time expended checking and/or investigating individual sureties.

##### INVESTIGATIONS OF INDIVIDUAL SURETIES

The Task Force on Individual Sureties, established to perform a study of individual sureties and draft proposed revisions to the FAR provision covering individual sureties, consists of representatives from eight different federal agencies. The Department of the Interior's representative on the task force is from Interior's Office of Inspector General (OIG). Thus, when the task force was deciding on ways to document the problems caused by the use of individual sureties, the Interior representative was asked to solicit such information from federal agency investigative units. In response to this request, in October 1988 Interior's OIG sent a letter summarizing the reported information to the Chairman, Task Force on Individual Sureties. The letter stated that an inquiry the Inspector General had sent federal agencies to obtain their views on individual sureties revealed 45 investigations involving alleged fraudulent activity. Fifteen federal agency investigative offices responded to the Inspector General's inquiry--13 OIGs and the investigative offices of the Departments of the Air Force and Navy. (The Department of the Army's Criminal Investigation Command did not respond to the inquiry.) Ten of the 15

investigative offices responding reported that they had one or more investigations, as shown in table 3.1.

Table 3.1: Investigative Offices With Cases Involving Alleged Surety Fraud

<u>Office</u>	<u>No. of cases</u>
Small Business Administration, OIG	10
Department of the Interior, OIG	9
General Services Administration, OIG	6
Department of the Navy, Naval Investigative Service	6
Department of the Air Force, Office of Special Investigations	6
Defense Criminal Investigation Service	2
Department of Agriculture, OIG	2
Department of Transportation, OIG	2
Department of Housing and Urban Development, OIG	1
Environmental Protection Agency	<u>1</u>
Total	<u>45</u>

According to the Interior Inspector General's letter, the investigative agencies believe the investigations have demonstrated that individual sureties are often secured by insufficient assets that have been over-pledged on numerous contracts with different federal agencies. The letter concluded that the ramifications of alleged fraudulent bonding are twofold: (1) the government reimburses the contractors for their bonding fee expenditures (approximately 3 to 5 percent of the total contract price) and (2) if a contractor defaults, the government, subcontractors, and material suppliers have little recourse because the performance bond and payment bond are worthless.

Between May 16 and July 25, 1989, we contacted the Department of the Army's Criminal Investigation Command and the investigative offices that had reported the most individual surety investigations to Interior's OIG. The purpose was to obtain updated information on the number and status of individual surety investigations. The information obtained follows:

- Department of the Army, Criminal Investigation Command. According to the information obtained from Command investigators in June and July 1989, the Command had about 50 open investigations of individual sureties. Some investigations were being conducted jointly with other federal agencies, and some individual sureties were involved in more than one investigation. The oldest cases were opened in calendar year 1987.
- Small Business Administration, OIG. As of May 22, 1989, the OIG had initiated a total of 11 investigations involving individual sureties since the beginning of fiscal year 1984. Of the 11 cases, 2 were still open and



9 had been closed. One closed case resulted in the debarment of the individual sureties involved. Four closed cases dealt with allegations that were not substantiated by the OIG's investigations. The remaining closed cases were referred to U.S. attorneys' offices for criminal prosecution. However, the U.S. attorneys' offices did not prosecute these cases.

- Department of the Interior, OIG. As of June 21, 1989, the OIG had a total of 10 investigations involving individual sureties. The earliest case goes back to approximately 1986; none of the cases have been closed.
- General Services Administration, OIG. The OIG had nine cases involving individual sureties open as of March 18, 1989. The earliest case dates back to February 1987. An OIG official said that more than one agency may have a case involving the same individual surety. For instance, one of the GSA cases involves an investigation that includes the Departments of the Interior and Agriculture. He said in this case, as well as others, each agency involved takes credit for its actions.
- Department of the Navy, Naval Investigative Service. On May 16, 1989, the Naval Investigative Service reported that it had a total of seven investigations involving individual sureties. The earliest case was opened in January 1988. One case had been closed because of lack of evidence. Of the six remaining cases, three were still being investigated by the Navy and three had been referred to multiagency task forces for investigation.
- Department of the Air Force, Office of Special Investigations. On July 25, 1987, an Office of Special Investigations headquarters official said that she was aware of 10 investigations that involve individual sureties and that all of these investigations were still open. The oldest case was opened in 1987 and the most recent case was opened in April or May 1989. This official said that a majority of the cases involved joint investigations with other federal investigative agencies but none had been turned over to a multiagency task force. In addition, the Office had nine open inquiries involving individual sureties. During an inquiry, preliminary evidence is gathered in order to determine if sufficient evidence exists to open an investigation.

On April 13, 1989, Interior's Deputy Inspector General told us that the investigative offices of the federal agencies are trying to (1) develop information that will demonstrate the magnitude of the problems that exist with individual sureties and (2) improve coordination between agencies. There are problems, however, connected with both of these efforts. According to the Deputy Inspector General, most of the investigations are still

open; therefore, details on these cases cannot be made public.<sup>1</sup> Furthermore, according to the Deputy Inspector General, privacy laws inhibit the federal agencies' exchange of unsubstantiated investigative information that might result in the identification of an individual.

In addition, several investigative office officials told us a problem exists in getting a U.S. attorney's office to accept individual surety cases for prosecution. To partially address this problem, and to address the problem of exchanging investigative information, agencies are establishing multiagency task forces in several locations across the nation. In these instances, investigators from several agencies work together to link alleged perpetrators of individual surety fraud to contracts awarded by more than one government agency. Such linkages strengthen a case and make it more attractive to prosecutors.

#### EXAMPLES OF LOSSES/PROBLEMS

Although no overall data exist, many of the federal agencies we contacted provided examples of problems resulting from the use of individual sureties. The following examples were obtained from VA, GSA, Army, and the Task Force on Individual Sureties.

##### Department of Veterans Affairs

In August 1988 the VA's contracting offices submitted information to VA headquarters on 76 contracts awarded during fiscal years 1987 and 1988 that had bonds supported by individual sureties (see sec. 2). In our review of this information, we noted six contracts, handled by four contracting offices, in which there were problems with individual sureties. Following is updated information on these contracts received from the VA's Deputy Assistant Secretary for Acquisition and Materiel Management on August 17, 1989:

- VA Medical Center (VAMC), Loma Linda, California. One subcontractor notified the contracting officer that it had not been paid by the same contractor on two separate

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<sup>1</sup>On June 14, 1989, the U.S. attorney for the Northern District of Texas announced that a federal grand jury in Fort Worth, Texas, had returned a 38-count indictment charging three individuals and a corporation with conspiring to defraud the U.S. government by submitting false contractors' bonds and supporting documents. According to the U.S. attorney's office, these bonds were in support of millions of dollars of federal construction and services contracts awarded by GSA and the Departments of the Interior, Agriculture, Veterans Affairs, Army, and Navy. The same week, the director of a company that provides individual sureties to construction contractors went on trial in Phoenix, Arizona, charged with 24 counts of fraud and conspiracy. Four of the other five individuals indicted in this case have pleaded guilty.

contracts. The VA had reimbursed the contractor \$16,946 for the bond fees on one contract and \$4,452 for the bond fees on the other contract. The contracts have been completed and the contracting officer has been unable to locate the subcontractor in question. According to the VA, the two individual sureties used to support the performance and payment bonds on these two contracts provided no evidence of the ownership or value of their stated assets. The VA further stated that the contractor had used two other individuals as bid bond sureties, and it subsequently learned that one of these sureties had no assets and the other had filed for bankruptcy 4 months before the bonds were submitted.

- VAMC, Memphis, Tennessee. One subcontractor filed a claim in excess of \$50,000 against the sureties after trying unsuccessfully to gain their cooperation and that of the contractor. Subsequently, the surety requested the contracting officer to withhold all moneys due the contractor at that time. According to the VAMC, three appeals have been presented to the VA's Board of Contract Appeals and numerous claims are pending resolution.
- VAMC, Perry Point, Maryland. One subcontractor has attempted to obtain payment for work performed on two contracts. According to the VA, the likelihood of the subcontractor's collecting from the four individual sureties is very small. In responding to a U.S. District Court, one surety signed an affidavit stating that he only signed a blank bond and that any further use of that bond was a fraudulent use of his signature. A second surety has refused to pay a judgment issued against him by the U.S. District Court. The U.S. marshal attempted to collect from this surety but returned the judgment "Nulla Bona" (i.e., no goods found for application of a levy). The subcontractor has been unable to locate the other two sureties, but the VA said that one of the sureties is currently an inmate at a federal prison. Both of the contracts are 100 percent complete. The VA had reimbursed the contractor \$36,860 (5 percent of the contract price) for bonds on one contract and \$5,389 (3.75 percent of the contract price) on the other contract.
- VAMC, Tampa, Florida. Subcontractors claim they have not been paid by the general contractor and are having problems obtaining payment from the sureties. Three legal firms representing three different subcontractors, plus another subcontractor not represented by an attorney, are involved. After much difficulty, one subcontractor located one of the sureties, filed a suit, and obtained a summary judgment. However, no funds have been collected and the VA stated that the likelihood of

the individual sureties fulfilling their responsibilities is considered negligible. The project was completed June 23, 1988, and the contractor was reimbursed \$4,500 (5 percent of the contract price) for bond fees.

In addition, there were (1) two contracts for which the contracting office had been told that one of the individual sureties was under investigation with regard to other contracts and (2) one contract in which the contractor was very late in starting work on the project because of bonding problems related to the use of individual sureties.

Subsequent to VA's August 1988 survey of its contracting offices, VA experienced problems with individual sureties on at least three additional contracts. As of August 17, 1989, the status of these contracts was as follows:

- VA investigated one contractor's individual sureties after receiving a complaint concerning a late payment by the contractor. One of the sureties involved acknowledged signing a blank bond but disclaimed any knowledge of or responsibility for the contract in question. He has refused to re-certify his assets and has indicated that he no longer wishes to be a surety on this contract. The VA also has learned that he has filed for bankruptcy with seven subcontractors and four different federal courts attempting to collect from him. The other surety and the bond brokerage firm that furnished these bonds to the contractor have been indicted for conspiring to defraud the U.S. government by executing and submitting false bonds. This project was 78 percent complete as of July 26, 1989. The VA reimbursed the contractor \$71,051 (3.75 percent of the contract) for bond fees.
- A contractor defaulted on a contract that was about two-thirds complete. Subcontractors are reported to be owed about \$150,000, but the VA states that the likelihood that the sureties will fulfill their responsibilities is negligible. The attorney for one surety has told the VA the surety has filed for corporate bankruptcy and has requested that any subcontractor inquiries be referred to him. The other surety has been the subject of an FBI investigation and the contracting officer has been unable to locate him. The VA reimbursed the contractor \$56,078 (4 percent of the contract price) for bond fees.
- Another contractor abandoned the contracted project after receiving the first (and only) progress payment of \$55,000, which included the cost of the payment and performance bonds. The VA states that the likelihood of the sureties fulfilling their responsibilities is negligible. The contracting officer has been unable to locate one surety. The other surety has stated, in

correspondence to subcontractors having claims against him, that he does not intend to honor his responsibilities as a surety. He has instructed subcontractors to contact the VA for payment, and the VA's contracting officer has advised the subcontractors to file suit in federal district court under the Miller Act. The start of this project had also been delayed because of surety problems. The low bidder was rejected because VA determined that the documentation submitted on the six individual sureties the contractor proffered (two at a time) was inadequate. The low bidder appealed the contracting officer's rejection of its proffered individual sureties to the VA's Board of Contract Appeals. The hearing on this appeal was scheduled for August 24, 1989, but the appeal was dismissed when the contractor and VA agreed to terms for settling this contract dispute.

#### General Services Administration

In its ad hoc study of individual sureties, GSA asked its regions what problems, if any, they had experienced in the performance of individual sureties. The Chicago Region's response mentioned one defaulted contract in which the individual sureties were the contractor's principal officers. The sureties arranged for another contractor to complete the project, but GSA received complaints from the second contractor's subcontractors and suppliers, who said they were not paid for work performed on or material supplied to the project. The only other GSA region to indicate even a potential performance problem was the National Capital Region, which reported the existence of a potential situation involving a pending contractor default.

In a March 24, 1989, letter to the Ranking Member of the Subcommittee on Government Activities and Transportation, House Committee on Government Operations, GSA's Associate Administrator for Acquisition Policy said that GSA's experience indicates that many of the problems associated with individual sureties have been eliminated by establishing a security interest requirement that is not in the current FAR. (See sec. 1 for an explanation of the internal GSA regulation provision on security interests.)

GSA officials said that in fiscal years 1988 and 1989 GSA suspended or debarred 10 parties from GSA contracting on the basis of offenses arising from their activities as or on behalf of individual sureties. They said the proposed rule would provide governmentwide effect to an agency's exclusion of an individual surety.

#### Department of the Army (Criminal Investigation Command)

The Criminal Investigation Command's Procurement Fraud Team at Fort George G. Meade, Maryland, is responsible for

investigating suspected procurement fraud cases in four states (Maryland, Virginia, West Virginia, and Delaware) and Washington, D.C., and serves as the focal point for all Command investigations of individual sureties in the northeastern United States. The team has one investigator who works on individual surety cases full-time, with other team members providing assistance as needed. The full-time individual surety investigator arrived at Fort Meade in October 1987. Between then and May 15, 1989, the team undertook 12 investigations of individual sureties. All 12 cases were open as of July 6, 1989, and the investigator believes that all of these cases involve some type of fraud, for example, the individual sureties misrepresented their assets and/or provided fraudulent financial statements.

The 12 cases involve 19 contracts. On 15 of these contracts, work was performed by the contractor before the possible problems with the individual sureties were noted. The contractors completed 10 of these contracts, had defaulted on 2 contracts, and were still working on 3 contracts as of June 6, 1989. According to the investigator, contracting agencies reimbursed the contractors for the bond fees, but the work performed on these contracts may have been performed without valid bonds. The amount of the bond fees was not indicated in the progress payment documentation for one contract, but a total of over \$1 million in bond fees was reimbursed on the others.

The four remaining contracts involve instances in which the individual sureties were rejected by the contracting office before the contractor was authorized to start work on the project. As a result, the only losses involved with these cases were (1) the staff time and expenses associated with reviewing/investigating the individual sureties and re-awarding the contracts and (2) the delays incurred in starting work on the projects.

#### Task Force on Individual Sureties

Files maintained by the task force's chairman contained numerous documents received from federal agencies that discussed losses and other problems associated with contractors' use of individual sureties. According to GSA's Associate Administrator for Acquisition Policy, more than 275 specific examples of serious problems associated with the use of individual sureties were received during preparations for congressional hearings on the proposed rule on individual sureties. Most of these examples were from two agencies--the Departments of the Army and the Navy.

Two adverse effects resulting from the use of individual sureties discussed in the task force's files were

- construction projects delayed because of the time required to check out individual sureties and obtain

replacement sureties when the individual sureties proffered initially were found to be unacceptable and

- subcontractors and material suppliers not paid by the defaulted contractor's individual sureties for labor and materials supplied to the projects.

The documents in the task force's files also discussed the types of problems the federal agencies found when they checked proffered individual sureties. These included (1) sureties claiming nonexistent assets, assets they did not have clear title to, and assets of questionable value, (2) failure to disclose other bond obligations, (3) affidavits that were executed before the agency had solicited bids, (4) fictitious financial statements, and (5) forged signatures of persons certifying that they know the proffered individual surety personally and, in their judgment, the individual is responsible and qualified to act as a surety. (See app. IV for specific examples of these and other misrepresentations found by federal agencies.)

## SECTION 4

### BID PROTESTS INVOLVING INDIVIDUAL SURETIES

During the period from January 1, 1985, through June 30, 1989, GAO issued 62 substantive decisions on questions related to the use of individual sureties for bid bonds. The Comptroller General decides bid protests under the authority of the Competition in Contracting Act of 1984 (31 U.S.C. 3551-3556). Interested parties, those whose direct economic interests are affected by an agency's action in awarding (or failing to award) a contract, may file a bid protest with GAO. Bonding requirements, particularly bid bonds, are among the issues that give rise to bid protests.

#### GAO PROCEDURES FOR REVIEWING BID PROTESTS

When reviewing bid protest cases, GAO bases its decision on the record compiled by the parties to the protest and does not perform an independent appraisal of the adequacy of bonding arrangements. The Comptroller General has held that the adequacy of a surety on a bid bond, or a Miller Act performance or payment bond, is a matter of bidder responsibility and not responsiveness.<sup>1</sup> Because determinations of responsibility involve the exercise of considerable discretion, as a matter of policy, GAO does not review a challenge to an affirmative determination that a bidder is responsible unless there is a showing of possible fraud or bad faith on the part of the agency.

#### ANALYSIS OF INDIVIDUAL SURETY DECISIONS

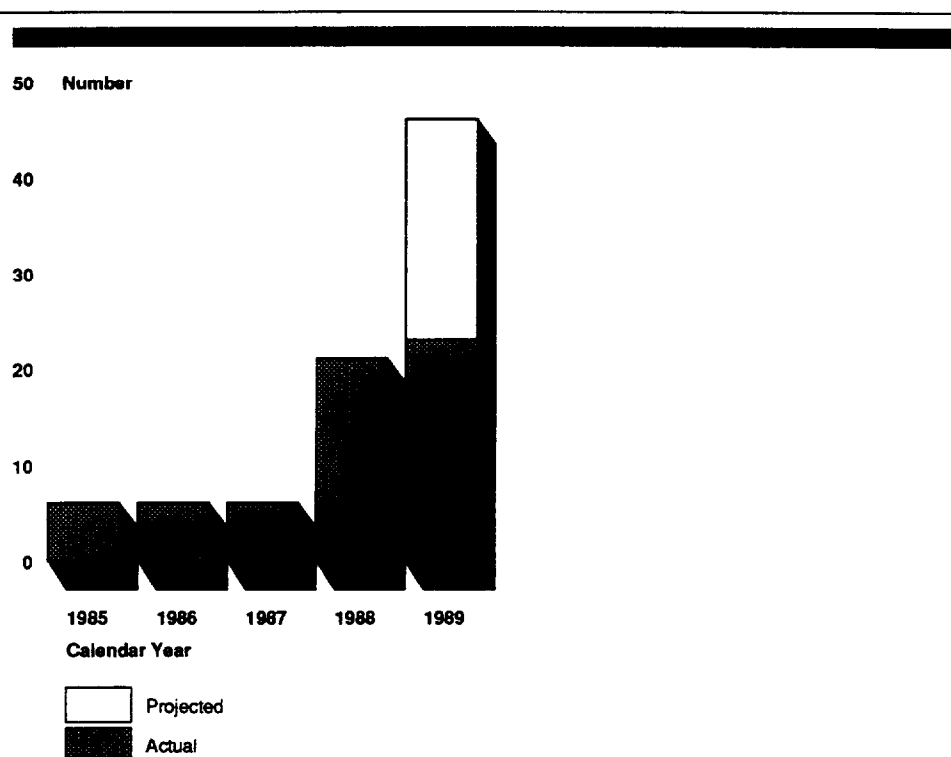
The number of bid protest decisions issued by GAO involving individual sureties increased sharply in 1988 and 1989. During the 3-year period from 1985 through 1987, the number of bid protest decisions involving individual sureties was stable at six per year. In 1988, however, there were 21 substantive decisions on individual surety matters. In addition, a total of 23 decisions were rendered during the first half of calendar year 1989. If this trend continues, the 1989 total will be double that of 1988. (See fig. 4.1.)

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<sup>1</sup>A bid is considered nonresponsive and is rejected automatically if the bid submission is incomplete or in some other way does not conform to requirements contained in the agency's invitation for bids--for example, when required bid bonds are not included in the bid package the bid is nonresponsive at bid opening. However, once an apparent responsive low bidder has been identified, questions as to that bidder's responsibility can be investigated and resolved within a reasonable time after the bid opening. Award is not made until the low bidder is found to be responsible.



Figure 4.1: Number of Individual Surety Bid Protests Decided by GAO (Jan. 1, 1985 Through June 30, 1989)



Numbers exclude reconsiderations, dismissals on procedural grounds, and advisory opinions on individual surety matters.

The 1989 projection assumes the same number of decisions will be issued during the last 6 months of 1989 as were issued during the first 6 months of the year.

In addition to the increase in the number of decisions issued, there has also been an increase in the number of protests sustained. A protest is sustained when it is determined that the agency has misapplied the law or regulations in awarding the contract. No protests involving individual surety issues were sustained in either 1985 or 1986. One was sustained in 1987, five in 1988, and two during the first 6 months of 1989. In each sustained protest, GAO directed the agency to make the contract award to the protester, terminating an existing contract if necessary. GAO also awarded the successful protesters their costs of filing and pursuing the protest, including attorneys' fees. Additionally, in one instance where the agency was unable to make an award to the protester because of lack of funds, bid preparation costs were also awarded to the protester.

#### ISSUES PROTESTED

The 62 bid protest cases analyzed in this fact sheet break down into nine major issues. These are (1) the surety's duty to disclose all outstanding bond obligations, (2) the surety's

financial ability to satisfy his or her bond obligations (net worth), (3) the documentation needed to substantiate a surety's net worth, (4) a bidder's proposed substitution of sureties, (5) the extent of a contracting officer's discretion in determining the acceptability of an individual surety, (6) a surety's integrity (rejection for unsound or unethical practices), (7) the agency's authority to place additional requirements on individual sureties, (8) the bidder's responsibility/responsiveness, and (9) miscellaneous issues. (See table 4.1 for a breakout showing who submitted the bid protests related to each issue.)

Forty-nine of the 62 bid protest decisions issued during the period were filed by low bidders who had been rejected because of defects related to their chosen individual sureties. Nine protests were from bidders who were next in line for a contract award if the low bidder were rejected because of a defect with its individual sureties. Two protests were submitted by other bidders, and two protests were filed on negotiated procurements where there was no low bid per se.

Table 4.1: Issues Addressed in the Individual Surety Bid Protests Decided by GAO (Jan. 1, 1985, through June 30, 1989)

<u>Issue</u>	<u>Low bidder</u>	<u>Next-in-line bidder</u>	<u>Others</u>	<u>Total</u>
Surety's duty to disclose all outstanding bond obligations	12	-	1	13
Surety's financial ability to satisfy its bond obligations	8	1	1	10
Documentation needed to substantiate a surety's net worth	8	-	-	8
Bidder's proposed substitution of sureties	5	2	-	7
Extent of a contracting officer's discretion	1	4	1	6
A surety's integrity	6	-	-	6
Agency's authority to place additional requirements on individual sureties	5	-	-	5
Bidder's responsibility/responsiveness	2	1	1	4
Miscellaneous	<u>2</u>	<u>1</u>	<u>-</u>	<u>3</u>
Total	<u>42</u>	<u>2</u>	<u>4</u>	<u>62</u>

Note: "Others" category includes protests on negotiated procurements and protests from bidders who were neither low nor next in line.

## DISCUSSION OF ISSUES IN BID PROTEST CASES

Where individual sureties are provided, the contracting officer must make a determination of the sureties' acceptability. The FAR requires that a bidder electing to use individual sureties must identify two persons willing to serve as sureties, each with sufficient net worth to cover the subject bond obligation in full as well as all other outstanding bond obligations. The Standard Form (SF 28), Affidavit of Individual Surety, is provided to assist the contracting officer in making a judgment as to the financial standing of the individuals offering to guarantee the bidder's obligation. A contracting officer may find a surety acceptable on the basis of the information on the form. However, a contracting officer is not permitted to reject a bid guaranteed by an individual surety solely because the SF 28 is incomplete or not completed correctly. If the contracting officer believes there may be a reason to reject the individual surety, he or she must investigate the surety further and make a determination of responsibility based on the information obtained.

GAO decisions have held that all outstanding obligations must be disclosed regardless of the degree of likelihood that the surety will be called upon to perform. According to our analysis, the most common problem addressed by the GAO bid protest decisions (13 decisions) is the failure of the surety to disclose other outstanding bond obligations on the SF 28. Some individual sureties mistakenly interpreted the requirement as not applying to other bid bonds. This error occurred when the surety reasoned that there was no way to predict whether the bid(s) he or she had guaranteed would be low. Another common error has been for the surety to fail to include bonds that he or she has underwritten for which the contractor's performance is complete, but the contract is still within a warranty period.

Although nondisclosure of bond obligations raises the possibility of other undiscovered obligations and casts doubt on the surety's ability to cover all his or her bonds, nondisclosure alone need not cause a bid to be rejected if there is some other basis to determine acceptability. Often when nondisclosure is the reason for rejection, there is a "pattern of nondisclosure" on two or more contracts.

Ten decisions involved the issue of whether the individual sureties had sufficient net worth to cover the bond obligation. The FAR requires both sureties to have sufficient assets to satisfy the obligations individually. Where assets are encumbered, owned jointly, or have no market, the surety might be unable to liquidate them in order to perform, if called upon to do so. If assets are overvalued, a similar inability to perform might result. Doubts about a surety's net worth may be resolved in the bidder's favor if the bidder places in escrow a cashier's check equal to the difference between its bid and the next lowest

bid. Otherwise, insufficient net worth of the sureties is a reason for rejecting the bid.

A related issue involves a bidder's failure to provide additional information requested by the contracting officer who is trying to verify a surety's net worth. If the bidder fails to comply with such a request within a reasonable amount of time, the contracting officer may reject the bid and make the award to the next lowest responsible bidder. Eight decisions concerned bids rejected when requested information was not provided within a reasonable time.

Even when additional information was provided, judgments about net worth are difficult to make. We noted that the contracting officer was often asked to evaluate unaudited financial statements or to make decisions about the value of unimproved real property or closely held stocks. However, absent proof of bad faith or fraud on the part of the contracting officer, his or her decision about the financial soundness of a proposed individual surety is final. Similarly, one contracting officer's finding that a surety is acceptable is not binding on other contracting officers or on other contracts. Six decisions involved questions regarding the contracting officer's discretion to reject individual sureties.

The requirement that contracting officers certify individual sureties can place a substantial burden on a contracting officer. For example, one GAO bid protest case describes a contracting officer spending a full week trying to trace and value assets listed on an SF 28, only to reject the bid in the end because the surety's holdings could not be verified. In contrast, other cases involved protests of contracting officers' approvals of individual sureties; in the protesters' view, the contracting officers had not sufficiently investigated sureties' assets and net worth. The potential for inconsistent treatment of individual sureties is illustrated by a protest case in which the low bidder was rejected because its individual sureties were found inadequate. Award was made to the next lowest bidder, despite the fact that the awardee offered the same individual sureties as the rejected low bidder. GAO sustained the original low bidder's protest.

Seven decisions involved questions about the number or identity of sureties or the substitution of individual sureties. When the bidders' individual sureties were questioned or rejected by the contracting officer, the bidders sometimes offered to substitute another surety. Such offers are nearly always rejected because substitution is not permitted, except in the instance where only one bid has been received.

Another element in the contracting officer's decision about an individual surety's acceptability is the surety's integrity. An individual who has been debarred from federal contracting or proposed for debarment may be rejected as an individual surety.

Likewise, individuals who are bankrupt, whose firms have defaulted on other government contracts in the past, or whose business practices are known to be unethical may be candidates for rejection. Because five of the six protests in this category involved individual sureties who had either been debarred or had been proposed for debarment, we presume bidders may not have access to this information when choosing an individual surety.

A final issue is additional requirements or restrictions placed on the use of individual sureties. Four of the five protests in this category involved a 1-year "class deviation from the FAR" in which the Navy evaluated the effects of placing additional requirements on individual sureties. GAO approved that temporary experiment in Comptroller General decision B-231086, dated July 5, 1988. However, the right to use individual sureties is preserved in 31 U.S.C. 9304(b)(1982), which provides that an "official may not require that [a] . . . surety bond be given through a guarantee corporation . . . ." GAO has not had occasion to address the validity of GSA's requirements that individual sureties either provide a covenant not to encumber real estate or deposit tangible assets. (See sec. 1.) However, in a case involving the Army Corps of Engineers, GAO held that similar requirements were unduly restrictive of competition and should not be used unless justified by a compelling need.

## SECTION 5

### PROPOSED CHANGES TO THE

#### FEDERAL ACQUISITION REGULATION

Testimony presented at a hearing held by the Senate Committee on Governmental Affairs Subcommittee on Federal Spending, Budget, and Accounting in August 1987 and the findings of the Task Force on Individual Sureties indicated a need to revise the FAR provision relating to individual sureties. The record of the Subcommittee's hearing generally describes reported incidences in which individual sureties failed to provide adequate payment protection for various small business subcontractors. As a result of this hearing and because of its concern that FAR provisions pertaining to individual sureties did not provide adequate guidance to government contracting officers and did not adequately protect the government's interests or the interests of workers and suppliers of materials for government contracts, the Office of Federal Procurement Policy requested the Civilian Agency Acquisition Council to undertake a comprehensive review of individual surety issues. The Task Force on Individual Sureties, which was established by the Council to conduct this review, found widespread evidence of systematic problems with the current method of handling individual sureties and drafted a proposed rule to strengthen the FAR provisions governing individual sureties.

On November 3, 1988, the proposed rule was published in the Federal Register. The proposed rule would require only one individual surety, instead of the two now required, but it would be more restrictive. Among other things, it would require a pledge of assets by the individual surety sufficient to cover the amount of the bond, prescribe the type of assets to be pledged, provide for exclusion of individual sureties for cause, and revise the Standard Form 28, Affidavit of Individual Surety.

Current FAR provisions require an SF 28. However, in their discussion of the proposed rule in the Federal Register, the Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council noted that

"...[e]xperience 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."

Comments submitted in response to the Federal Register announcement of the proposed rule and testimony given at a

hearing on the proposed rule held by the Subcommittee on Government Activities and Transportation, House Committee on Government Operations, on February 22, 1989, disclosed sharp disagreement on the merits of the proposal. Federal agencies, the Associated General Contractors of America (an association representing more than 32,500 firms, including 8,000 general contracting construction companies), the American Subcontractors Association (representing more than 8,000 firms engaged in all major construction trades and 15 specialty trade associations), and the Surety Association of America (representing more than 600 companies writing corporate surety bonds) supported the proposed rule. On the other hand, associations representing minority contractors (the National Association of Minority Contractors, which represents about 3,500 member contractors; the National Hispanic Association of Construction Enterprises, which represents over 1,500 members; and the National Indian Contractors' Association) and firms representing individual sureties opposed the proposed rule. They acknowledged the need for changes to the current regulation, but contended that the proposed rule is much too restrictive and would virtually eliminate individual sureties. They stated that individual sureties are currently the only form of bonds available to many minority contractors and that their elimination would have an adverse effect on the ability of minorities to bid on federal construction contracts.

According to the comments submitted by the manager of the Treasury Department's Surety Bond Branch, each corporate surety maintains assets that are reserved for future loss payments, and the adequacy of these reserves is determined by independent auditors and actuaries, the surety's actuaries, and/or state regulatory officials. Further, most corporate sureties maintain professional claims staffs or, as an alternative, hire outside claims attorneys to ensure that claims are handled properly. According to the branch manager, it would be cost prohibitive for individual sureties to provide the service and assurances that are expected from corporate sureties. Without the necessary assurances, however, it is unrealistic to expect the federal government to devote resources to evaluating individuals' financial positions and their ability to provide adequate guarantees to the federal government. In addition, although an individual's financial position may look satisfactory at the time a bond is presented, there is nothing to prevent an individual from depleting assets after the bond is accepted. Further, there is no real protection for the government without a security interest in the individual's assets. With a security interest, and stringent guidelines for asset acceptability, there is no need to expend government resources to develop an individual surety evaluation process.

The Task Force on Individual Sureties has completed its review of public comments on the proposed rule and has revised the rule to incorporate changes resulting from its analysis of the public comments and a subsequent review by the Civilian

Agency Acquisition Council and the Defense Acquisition Regulatory Council. On July 27, 1989, the FAR Council, consisting of the Acting Administrator of the Office of Federal Procurement Policy and the senior procurement executives of GSA, Department of Defense, and the National Aeronautics and Space Administration, approved the promulgation of the regulation containing the coverage agreed to by the Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council as a final rule. Representatives of the FAR Council agreed to notify representatives of the Congress of the intent to publish a final rule.



FEDERAL GOVERNMENT UNITS  
AND PRIVATE SECTOR ORGANIZATIONS  
CONTACTED BY GAO

FEDERAL GOVERNMENT

Department of Defense

Office of the Assistant Secretary of Defense, Production &  
Logistics  
Office of the Inspector General

Department of the Army

Corps of Engineers  
The Judge Advocate General, Contract Appeals Division -  
Bonds Team  
Criminal Investigation Command

Department of the Navy

Naval Facilities Engineering Command  
Naval Investigative Service

Department of the Air Force

Acquisition, Contract Manufacturing Policy, Operational  
Policy  
Office of Special Investigations

General Services Administration

Office of Acquisition Policy  
Office of the Inspector General

Department of Veterans Affairs

Office of Acquisition and Materiel Management  
Office of Inspector General

Department of the Interior, Office of Inspector General

Environmental Protection Agency, Office of Inspector General

Small Business Administration

Office of Advocacy  
Office of Inspector General

Task Force on Individual Sureties

CONSTRUCTION INDUSTRY

Associated General Contractors of America  
National Association of Minority Contractors  
American Subcontractors Association

SURETY BOND INDUSTRY

Surety Association of America  
National Association of Surety Bond Producers  
The American Surety Association

CONTRACTS SUBJECT TO THE MILLER ACT  
AWARDED TO SMALL BUSINESSES BY VA  
DURING FISCAL YEARS 1987 AND 1988

Dollars in thousands

	<u>Type of contractor</u>		
<u>Fiscal year 1987</u>	<u>Small, disadvantaged</u>	<u>Other small businesses</u>	<u>Total small businesses</u>
Total contracts awarded			
Number	185	864	1,049
Dollar value	\$90,562	\$239,680	\$330,242
Contracts using individual sureties			
Number	25	13	38
(percent of total)	(13.5)	(1.5)	(3.6)
Dollar value	\$20,981	\$ 3,434	\$ 24,415
(percent of total)	(23.2)	(1.4)	(7.4)
<u>Fiscal year 1988</u>			
Total contracts awarded			
Number	160	705	865
Dollar value	\$67,139	\$220,008	\$287,147
Contracts using individual sureties			
Number	21	17	38
(percent of total)	(13.1)	(2.4)	(4.4)
Dollar value	\$10,740	\$ 3,518	\$ 14,258
(percent of total)	(16.0)	(1.6)	(5.0)

Source: GAO analysis of VA data.

CONTRACTS SUBJECT TO THE MILLER ACTAWARDED TO SMALL BUSINESSES BY GSADURING FISCAL YEAR 1988

Dollars in thousands

	<u>Type of contractor</u>		
	<u>Small, disadvantaged</u>	<u>Other small businesses</u>	<u>Total small businesses</u>
Total contracts awarded			
Number	28	607	635
Dollar value	\$14,519	\$200,627	\$215,146
Contracts awarded using individual sureties			
Number	-	27	27
(percent of total)	(-)	(4.4)	(4.3)
Dollar value	0	\$ 6,119	\$ 6,119
(percent of total)	(0)	(3.0)	(2.8)
Total contracts terminated for default			
Number	2	10	12
Dollar value	\$ 217	\$ 2,006	\$ 2,223
Contracts terminated for default that used individual sureties			
Number	-	2	2
(percent of total)	(-)	(20.0)	(16.7)
Dollar value	0	\$ 662	\$ 662
(percent of total)	(0)	(33.0)	(29.8)

Source: GAO analysis of GSA data.

EXAMPLES OF PROBLEMS FEDERAL AGENCIESHAVE HAD INVOLVING INDIVIDUAL SURETIESDEPARTMENT OF THE NAVY, NAVAL FACILITIES  
ENGINEERING COMMAND, SOUTHERN DIVISION

In a letter dated February 17, 1989, the Southern Division's Office of General Counsel provided the Chairman, Task Force on Individual Sureties, a lengthy description of the problems the General Counsel's office has noted regarding the use of individual sureties and included several specific examples. The following are some of the types of problems noted in the Office of General Counsel's letter:

- Most individual sureties do not have the ability or the resources to personally complete a defaulted job.
- There are far more small business subcontractors and suppliers in jeopardy of not being paid than there are small business contractors who have difficulty obtaining commercial bonding.
- The information individual sureties are supposed to disclose on other bond obligations is often misleading, inaccurate, and unverifiable.
- In attempting to verify the stated net worth on the Affidavits of Individual Surety, the division has generally found the assets to be grossly overstated, nonexistent, and difficult to identify. This is a very time-consuming process. However, because of the large number of inaccuracies and misrepresentations, the division cannot afford to do any less.
- In most cases, the agency's contract specialist is required to wade through reams of worthless paper to find out that a multi-million-dollar net worth claim is based on an inactive corporation, nonproducing mining rights, and stock in bankrupt companies. This is a very time-consuming exercise. For example, reviewing three sets of bonds offered by a contractor for one negotiated procurement award took approximately 120 hours of the contract specialist's time.
- Most of the people signing the Certificate of Sufficiency either have no idea what they are doing or they knowingly participate in misrepresentation. The Certificate of Sufficiency is on the reverse side of the Affidavit of Individual Surety and must be signed by an officer of a bank, a judge, a postmaster, or other officer of the

United States acceptable to the agency. The signer certifies that to the best of his or her knowledge the individual surety is personally known and in the signer's judgment responsible and qualified to act as a surety. In addition, the signer must certify that to the best of his or her knowledge the facts shown in the affidavit are true.

- In order to support their net worth, many individual sureties submit statements from accountants. For the most part, these statements are as unreliable as the Certificates of Sufficiency.
- We have experienced many instances in which subcontractors and suppliers are not paid and individual sureties are nonresponsive.

DEPARTMENT OF THE ARMY,  
CORPS OF ENGINEERS

Savannah District

According to a Savannah District Office letter, dated February 15, 1989, the district had approved less than 10 percent of the people offered as individual sureties during the preceding year. The most common reason for refusing individual sureties was the lack of documentation to support claims of owned assets. The next most common reason involved the types of assets used to establish the net worth of the surety. In many cases, the assets owned by individual sureties do not provide acceptable liquidity. For example, oil and gas leases were not viewed as being convertible into cash in a time frame that would provide the funds necessary to complete the project or pay subcontractors and suppliers. Additionally, the district had individual sureties proffered who were connected with surety brokers that had been suspended or debarred by the Army or GSA. Finally, investigations of some individual surety applications revealed possible fraud.

The poor quality of the individual sureties offered to the Savannah District also has caused serious problems in completing the district's construction program and in reaching the district's contract placement goals for small and small, disadvantaged businesses. Several contracts had to be terminated at the outset for failure to provide adequate sureties, causing considerable project delays. In addition, two large, half-completed projects are threatened with termination because of the contractor's inability to obtain adequate sureties to replace individual sureties that the district had initially approved but later determined to be unsuitable.

The district's comments included specific examples of (1) a surety accepted on two projects who they subsequently learned was under indictment for fraud, (2) a surety who they subsequently learned had not listed other bond obligations and who reportedly had been sued for nonperformance on several defaulted projects, (3) a Certificate of Sufficiency that was signed by a person who purported to represent a bank that did not exist, and (4) a surety who did not own most of the land that had been offered as part of his net worth.

#### Alaska District

According to a letter from the Alaska District dated February 15, 1989, two points must be stressed. Investigating an individual surety's claimed net worth has become so technically complicated and time-consuming that procurement offices have difficulty performing these investigations adequately. District officials believe that the only practical way to verify the existence, ownership rights, and value of assets pledged by individual sureties is to require title certificates or bills of sale and independent professional appraisals. They also believe sureties should be required to retain the assets throughout the term of the bond obligation. However, under the current FAR these steps are difficult to enforce and are subject to protest as an abuse of the contracting officer's discretion. The second point the district stressed is that subcontractors and suppliers have no recourse except the sureties when a prime contractor refuses to pay them for work for which the prime has been paid. The subcontractor has no lien rights against a federal project. In addition, the government, having already paid for the work, has no authority or obligation to pay the unpaid subcontractors and suppliers.

The district also discussed its experiences with individual sureties on two of its projects. The individual sureties offered by the low bidder on one contract were rejected because they did not own real estate that was claimed. On the second contract, the low bidder offered individual sureties who were accepted after a review of financial statements and other information. Questions about arithmetic errors and other technical defects on the affidavits led to a request by the Army Bonds Team for further investigation of the sureties' net worth. This investigation disclosed that the sureties' claimed net worth was virtually worthless. The contractor was directed to provide additional sureties. After some delay, he refused to do so. The contractor had been paid for the subcontractors' work but failed to pay them, and the government has no money left in the contract to pay the subcontractors.

Detroit District

A letter from the Corps' Detroit District Office, dated February 16, 1989, stated that the office is concerned that currently there is no way to verify in a timely manner the information offered by the individual sureties or support for their claims of assets and also no way to ensure that the assets will not be disposed of during the performance of the contract.

The letter also discussed the district's experiences with individual sureties offered on contracts involving two projects. On the first project, the three individuals offered as sureties did not have adequate assets to cover the performance/payment bonds. The two individuals next offered were eventually accepted after review of the documents presented as representing their assets. The Notice to Proceed on this project was delayed, however, because of the time needed to review the supporting documentation. That delay resulted in the work being done at a time when weather conditions were less than favorable and, ultimately, in the work being delayed until the following spring. When it was time for the contractor to resume in the spring, the contractor told the government that the individual sureties would not correct a technical deficiency in the bond (i.e., execute both signatures on the same performance and payment bond documents). Ultimately it became necessary to terminate the contract for default.

The second project also was delayed because of the time required to review individual sureties. The first two individuals offered as sureties were rejected when the review revealed (1) problems with their past practices in the area of individual sureties and (2) that they were under investigation by the Federal Bureau of Investigation. The two individuals offered next were eventually accepted after a review of the voluminous documents that represented their assets. The Notice to Proceed on the contract was delayed for the review, however, and the work was initiated in a season when the weather conditions were less favorable and the completion of the project has been delayed until the spring. Now there is reason to believe that the individual sureties being used may not be acceptable in the spring. If the contractor is unable to obtain acceptable bonding, this could result in yet another contract terminated for default.

Huntington District

The Huntington District letter, dated February 14, 1989, stated that the district has had only one experience with individual sureties in the past 2 years. A follow-up investigation revealed that the signature on one of the Certificates of Sufficiency had been forged. This matter is



being investigated by the Army's Criminal Investigation Command. The contract was subsequently terminated for default because the contractor failed to provide the required performance and payment bonds.

#### Pacific Ocean Division

According to the Pacific Ocean Division's letter dated February 15, 1989, the burden on the contracting officer of determining the adequacy of individual surety bonds sufficient to protect the government's interest is tremendous. If the contractor's bonds are deemed unacceptable, the government must inform the contractor that it must provide other sureties. If the contractor is unable to come up with other sureties, the government must default the contractor. If this is contested by the contractor, the government has the burden of proving in a protest or litigation the reason for the rejection of the bonds.

The letter also discussed the district's review and rejection of the individual sureties submitted by a bidder in response to one of the district's invitations for bids. According to the district, the bid opening date was near the end of the fiscal year when there is an urgency to award contracts before funds are lost. Thus, the agency needed to satisfy itself, in a short period of time, that the government's interests would be protected. However, the district found that the Certificate of Sufficiency was not signed by a properly authorized official and there was a discrepancy in the dates of the bid bond and the Affidavit of Individual Surety. As a result, the low bid was rejected and the contract was awarded to the second low bidder. The district said that it had other problems involving individual surety bonds in which the affidavits and bonds were obviously not signed by the same person or the stated assets were inadequate.

#### Louisville District

According to a February 22, 1989, letter from the Louisville District Office, the district's problems with individual sureties have been twofold. First, the district has become rather strict in evaluating and approving individual sureties on both bid bonds and performance and payment bonds. Delays occur when sureties are rejected and bidders or contractors are required to obtain adequate bonds. Moreover, the cost of the project is indirectly increased when the low bidder who has used such sureties is declared nonresponsible and the award must be made to a higher bidder. However, the district's greatest problems have occurred in situations in which it has rejected individual sureties on bid bonds. This has caused the disgruntled bidders to protest to GAO, with the resultant delay in either the contract award or the

issuance of the Notice to Proceed. To date the district has successfully defended all of these cases.

DEPARTMENT OF JUSTICE, FEDERAL BUREAU OF  
INVESTIGATION, BALTIMORE OFFICE

According to a February 14, 1989, letter from the Bureau's Baltimore Office, it is investigating allegations that a group of individuals have conspired to defraud the government. Individual surety bonds have been provided to contractors on federal projects that have inadequate or nonexistent financial backing, and numerous false statements have been offered to the government to cover this fraud. Further, investigations by the Baltimore Office have revealed that this abuse is not limited to an isolated instance but rather has occurred widely. Other investigations relating to the individual surety bonding program are underway in other Bureau field divisions nationwide.

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