

Redacted

**AUDIT OF LOSS ADJUSTMENT EXPENSES  
INCURRED ON QUALITY TRUST, INC. BONDS**

**AUDIT REPORT NUMBER 2-24**

**AUGUST 19, 2002**

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U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
WASHINGTON, D.C. 20416

**Audit Report**

**Issue Date: August 19, 2002**

**Number: 2-24**

**To:** Dionne Neal  
Acting Associate Administrator, Office of Surety Guarantees

**From:**   
Robert G. Seabrooks  
Assistant Inspector General for Auditing

**Subject:** Audit of Loss Adjustment Expenses Incurred on Quality Trust, Inc. Bonds

As a result of a complaint received from CFRA EX. 6 Quality Trust, Inc. (Quality Trust), we completed an audit of the loss adjustment expenses (LAEs) claimed on all SBA guaranteed bonds issued to Quality Trust by Gulf Insurance Group (Gulf). LAEs are amounts actually paid by the surety which are specifically allocable to the investigation, adjustment, negotiation, compromise, settlement of, or resistance to a claim for loss resulting from the breach of the terms of the bonded contract and for court costs and reasonable attorney's fees incurred to mitigate loss. Gulf, a prior approval surety in SBA's Surety Bond Guarantee program, issued four SBA guaranteed bonds to Quality Trust from October 1994 to October 1996. As a result of cash flow difficulties, the Principal was late in paying many project subcontractors and suppliers and approximately \$221,619 of payment claims were filed against three of the four issued bonds. Although Gulf was not required to make payment to any of the claimants, Gulf incurred \$91,077 of LAEs to investigate, negotiate and resist the claims, and pursue recovery. As a result of its recovery efforts, Gulf received \$50,725. SBA reimbursed Gulf its guaranteed percentage of the LAEs, less recoveries, incurred on the Quality Trust bonds. The Principal asserts that Gulf's local counsel incurred unnecessary costs and that SBA's reimbursement to Gulf for its guaranteed percentage of the costs was improper.

### OBJECTIVE AND SCOPE

The objective of our audit was to determine if: (1) the \$91,077 of LAEs claimed by Gulf were allocable, allowable and reasonable, and (2) the offset of LAEs against recoveries and SBA's reimbursement of its guaranteed percentage of the remaining LAEs were appropriate in accordance with SBA's regulations. Our audit was limited to a review of the LAEs claimed for the SBA guaranteed Quality Trust bonds. We reviewed SBA's underwriting and claim files and interviewed SBA and Gulf officials. Fieldwork was conducted from January 2002 to June 2002. The audit was conducted in accordance with Government Auditing Standards.

## AUDIT RESULTS

The audit found that \$89,530 of the \$91,077, or 98 percent of the LAEs claimed by Gulf were allocable, allowable and reasonable. The audit also found that with minor deficiencies the offset of LAEs against recoveries and SBA's reimbursement of its guaranteed percentage of the remaining LAEs were appropriate in accordance with SBA's regulations. Gulf incurred and was reimbursed its guaranteed percentage by SBA for \$1,547 of LAEs that were not specifically allocable to a claim for loss resulting from the breach of the terms of the bonded contract. As a result, we recommended that SBA recover its guaranteed percentage of the questioned LAEs, or \$1,392 from Gulf.

### **Finding 1: Unallowable LAEs were Incurred by Gulf and Reimbursed by SBA**

Gulf claimed \$1,520 for LAEs incurred to resist an invalid claim that did not result from a breach of the terms of the bonded contract and \$27 for LAEs incurred for work that was unrelated to a claim for loss. SBA's regulations state that loss includes expenses for amounts paid that are specifically allocable to the investigation, adjustment, negotiation, compromise, settlement of, or resistance to a claim for loss resulting from the breach of the terms of the bonded contract. SBA reimbursed Gulf \$1,392 for these unallowable LAEs.

#### *LAEs incurred for an Invalid Payment Claim*

Gulf incurred \$1,520 of LAEs that were not specifically allocable to a claim for loss resulting from the breach of the terms of the bonded contract. The LAEs resulted from the surety's resistance to a claim by the producing agent who advanced a \$3,413 bond premium to the Principal and was never reimbursed. Gulf's claims manager determined that the claim was not a valid claim to the Miller Act payment bond because the claimant did not supply labor or materials to the project. Additionally, the claim was time barred, as it was not submitted within one year from the date the premium was advanced. Gulf officials stated that they are required to perform a proper and independent investigation, notwithstanding the fact that the claim is ultimately determined to be incorrect or without merit, or subject to complete defenses. The Principal, however, did not breach the terms of the bonded contract by not reimbursing the producing agent for the advanced premium and therefore, the resulting LAEs should not have been submitted to SBA for reimbursement. Of the \$1,520 of LAEs determined to have been incurred for this matter, \$281 was derived from the auditors' estimation of LAEs. It was necessary to use an estimate because Gulf's attorney lumped fees related to different matters into one invoice line item.

#### *LAEs Incurred for Internal Processes of Gulf's Attorney*

Gulf incurred \$27 of LAEs for their attorney to review documentation related to Gulf's claims manager's name change. These attorney fees were not specifically allocable to a claim for loss.

**Recommendation:**

- 1A. We recommend that the Acting Associate Administrator, Office of Surety Guarantees (OSG) take appropriate action to recover \$1,392 from Gulf for SBA's guaranteed percentage of the unallowable LAEs described above.

**Other Matter:**

During our audit, the following matter came to our attention. It was not directly related to the audit objective and therefore, was not included as a finding. We believe, however, that the condition warrants corrective action by SBA management and accordingly, it is included herein.

**SBA did not Give Gulf Permission to Close Its Files in a Timely Manner**

By letter dated March 13, 2000, Gulf requested SBA's permission to close its Quality Trust files, explaining that it was not economically feasible to pursue indemnity and that there was a small chance of recovery. OSG received the letter on March 27, 2000. There were also status reports in SBA's claim files dated January 31, 2001, and May 17, 2001, that clearly noted Gulf had sought SBA's approval to close its files. As of June 6, 2002, Gulf had not received permission from SBA to close its files.

SBA's regulations state that a prior approval surety must pursue all sources of salvage and recovery until SBA concurs with the surety's recommendation for a discontinuance or settlement. The surety must certify that continued pursuit of salvage and recovery would be neither economically feasible nor a viable strategy in maximizing recovery. If SBA had approved Gulf's discontinuance of its pursuit of recovery in March 2000, LAEs of at least \$1,088 may not have been incurred. OSG believes that a prior approval surety should be able to close its files when it determines that pursuit of recovery is no longer economical and should only be required to inform SBA when they have done so. OSG stated that it would take appropriate actions to revise SBA's policies and procedures accordingly.

**Recommendation:**

- 2A. We recommend that the Acting Associate Administrator, Office of Surety Guarantees take expedient action to approve file closures on requests from sureties to discontinue pursuit of recovery and revise SBA's policies and procedures accordingly to avoid incurrence of unnecessary LAEs in the future.

**Gulf's Response:**

Gulf took a neutral position to Finding 1, stating that it would be cost prohibitive to further contest the issue. Although Gulf further stated that it took exception to some of the auditors' conclusions, in the interest of continuous harmonious relations, practicality, fiscal

responsibility, and without admitting any wrongdoing, Gulf agreed to reimburse \$1,392 to SBA in order to put closure to the issue. Gulf's response is included in its entirety as Attachment 1.

**SBA Management's Response:**

The Acting Associate Administrator, Office of Surety Guarantees concurred with our recommendations. OSG's response is included in its entirety as Attachment 2.

**Office of Inspector General's Evaluation of Responses:**

The comments provided by Gulf and the Acting Associate Administrator, Office of Surety Guarantees are responsive to our findings and recommendations.

**\*\*\*\***

The findings included in this report are the conclusions of the Office of Inspector General's Auditing Division. **The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.**

Please provide us your management decision for each recommendation within 80 days. Your management decisions should be recorded on the attached SBA Forms 1824, Recommendation Action Sheet, and show either your proposed corrective action and target date for completion, or explanation of your disagreement with our recommendations.

Should you or your staff have any questions, please contact Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-7577.

# Gulf Insurance Group

Attachment 1

August 8, 2002

Mr. Robert G. Seabrooks  
Assistant Inspector General For Auditing  
Small Business Administration  
Office of Inspector General  
Auditing Division, Mail Code 4112  
409 3<sup>rd</sup> Street, SW  
Washington, D.C. 20416

Re: Quality Trust, Inc.

Dear Mr. Seabrooks:

Thank you for forwarding a copy of your draft audit report concerning Gulf's loss adjustment expenses incurred on Quality Trust, Inc. bonds. This letter is sent to you for settlement purposes only. It should not be considered as an admission of liability or wrongdoing.

Initially, Gulf is pleased, that but for a minor amount, your audit found that the expense incurred by Gulf in investigating, negotiating and resolving claims, and pursuing recovery were necessary and proper. Along those same lines, Gulf is also gratified that the audit results confirm Gulf's counsel expenses also were necessary and proper. We take a neutral position to SBA's finding that of the \$91,077.00 in loss adjustment expense, a total of \$1,547.00 is disallowable because it would be cost prohibitive to further contest this issue.

Gulf would, however, like to comment on the following points contained in the draft audit report. In response to SBA's statement that Quality Trust's inability to pay project subcontractors and suppliers was caused by a significant change in one of its bonded projects, we call your attention to the documents and reports turned over to the SBA, which state that Quality Trust's problems were due to several factors other than change order.

In closing, though we take exception to some of the SBA's conclusions, in the interest of continued harmonious relations, practicality, fiscal responsibility, and without admitting any wrongdoing, Gulf, in this particular case, will reimburse the SBA the \$1,392.00 it seeks in order to put closure to this issue. Payment will be forthcoming under separate cover. In the meantime, should you have any questions, please contact me.

Sincerely,


FOIA Ex. 6



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, D.C. 20416

DATE: August 16, 2002

TO: Robert G. Seabrooks, AIG for Auditing  
Office of Inspector General

FROM: Dionne Neal, Acting Associate Administrator   
Office of Surety Guarantees

SUBJ: Draft Audit Report of Loss and Adjustment Expenses Incurred on Quality  
Trust, Inc. Bonds

I have reviewed the draft audit report on the loss adjustment expenses incurred on the Quality Trust, Inc. bonds. The only audit finding was that SBA reimbursed Gulf Insurance Company \$1,392 in unallowable losses and expenses (LAEs).

I concur with the Office of Inspector General's (OIG) recommendation that the Office of Surety Guarantees (OSG) take appropriate action to recover from Gulf Insurance Company, the \$1,392 in unallowable LAEs.

Although the "Other Matter" was not a part of the audit objective and therefore not included in the findings, I concur with OIG's recommendation that OSG take expedient action to approve file closures on requests from sureties and revise such program procedures.

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