




**U.S. Small Business Administration  
Office of Inspector General  
Washington, DC 20416**

<b>AUDIT REPORT</b>
<b>Issue Date:</b> September 30, 1998
<b>Number:</b> 8-8-H-009-026

TO: Robert J. Moffitt  
Associate Administrator  
Office of Surety Guarantees

FROM:   
Peter L. McClintock  
Assistant Inspector General  
for Auditing

SUBJECT: Audit of Safeco/First National Surety Company

This transmits the Independent Accountant's Audit Report on Safeco / First National Surety Company (Safeco). The report by Cotton & Company, CPAs, discusses problems related to (1) a bond rider issued that did not bind the co-obligee to the contract; (2) a bond issued after work had commenced; (3) bonds issued for a single project that exceeded the statutory limit; (4) underwriting files that were not retained; (5) unallowable expenses claimed; (6) recoveries not pursued; and (7) surety fees which were not remitted to SBA. As a result, we are questioning \$486,388 and making 7 recommendations.

You may release this report to the duly authorized representative of Safeco at your discretion. This report may contain proprietary information subject to the provisions of 18 USC 1905. Therefore, you should not release this report to the public or another agency without permission of the Office of Inspector General.

**The findings in this report are the auditors' conclusions, and the report recommendations are subject to review, management decision, and action by your office in accordance with existing Agency procedures for audit follow-up and resolution.** Please record your management decisions on the SBA Forms 1824, Recommendation Action Sheets, which are provided with this report, within 30 days.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations, at (202) 205-7204.

**INDEPENDENT ACCOUNTANT'S  
REPORT ON THE PERFORMANCE AUDIT OF  
SAFECO/FIRST NATIONAL**

**Performed by:**

**Cotton & Company, LLP  
Certified Public Accountants  
333 North Fairfax Street, Suite 401  
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# COTTON & COMPANY

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June 16, 1998

U.S. Small Business Administration  
Office of Inspector General

## BACKGROUND

The Small Business Administration's (SBA) Surety Bond Guarantee (SBG) Program, authorized by the Small Business Investment Act of 1958, as amended, was created to assist small emerging and minority construction contractors. SBA indemnifies surety companies from potential losses by providing a Government guarantee on bonds issued to the contractors. SBA guarantees 70 percent for contracts not exceeding \$1.25 million under the Preferred Surety Bond (PSB) Program. The SBG program is administered by SBA's Office of Surety Guarantees (OSG).

## OBJECTIVE, SCOPE, AND METHODOLOGY

SBA's Office of Inspector General (OIG) requested Cotton & Company to conduct a performance audit of Safeco/First National Surety Insurance Company. The primary objectives were to determine if:

1. Safeco/First National complied with SBA's and its own policies and procedures in applying for bond guarantees for which SBA paid claims.
2. Claims and expenses paid by SBA were allowable, allocable, and reasonable.
3. Fees due SBA were accurately calculated and remitted in a timely manner.

We obtained the Claim Payment History report from SBA's OSG, which lists all claim payments made to and recoveries received from Safeco/First National since November 1992, when it started in the program, through April 1998. This report showed six defaulted bonds that had claim payments. We judgmentally selected three of the six bonds to test claims and underwriting procedures. Total claim payments (net of recoveries) in the sample equaled [ Ex. 4 ] Total claim payments (net of recoveries) in the population equaled [ Ex. 4 ] Thus, the sample amount represents 95.88 percent of the total population. We selected four additional bonds that did not have claims paid by SBA and reviewed Safeco/First National's compliance with underwriting procedures. Sample bonds are listed in the attachment.

FoIA Ex. 4

We tested sample bonds for compliance with SBA regulations for underwriting and fees by reviewing underwriting files and Safeco/First National's accounting records. We tested all claims incurred under the defaulted sample bonds through April 30, 1998, by reviewing Safeco/First National's supporting documentation in the claim files and accounting records. We obtained a list of all SBA guaranteed final bonds from Safeco/First National and identified all contractors with total bonds exceeding \$1.25 million for contracts with the same obligee and bond issue dates within several months. We then reviewed project descriptions to determine if the bonds were for a single project divided into more than one contract. We also determined if any bonds were issued to contractors that were in default status prior to the bond execution dates.

We conducted fieldwork in June 1998 at Safeco/First National's offices in Seattle, Washington. The audit was conducted in accordance with Government Auditing Standards, 1994 Revision, except as described below.

#### FOLLOW-UP ON PRIOR AUDITS

The scope of our audit did not include following up on findings and recommendations from previous audit reports.

#### AUDIT RESULTS AND RECOMMENDATIONS

Safeco/First National did not always comply with SBA's policies and procedures for underwriting bonds. Specifically, Safeco/First National issued a bond rider to add a co-obligee that was not bound by the contract with the principal; issued a bond after work started under the contract without obtaining SBA approval; issued bonds for contracts constituting a "single project" that aggregated more than \$1.25 million; and did not maintain all required underwriting documentation. Safeco/First National also claimed unallowable expenses, including loss and expenses for defending itself against claims that it breached its duties and responsibilities under a bond and legal fees and expenses that constitute advances or loans to the principal. In addition, Safeco/First National did not pursue recovery under a subordination agreement. Finally, Safeco/First National did not remit fees related to contract increases to SBA. As a result, we questioned [ EX. 4 ] SBA's guaranteed portion of claims requested for reimbursement.

We conducted an exit conference with Safeco/First National personnel on June 16, 1998. Safeco/First National disagreed with the findings, except one finding related to [ EX. 4 ] [ FOIA EX. 4 ] Its response to each finding is included in the appendix to this report.

Our findings and recommendations are discussed in detail below.

[ FOIA EX. 4 ]

Safeco/First National issued performance and payment bonds to [ EX. 4 ] for [ EX. 4 ] the contract amount. The contract was between 65 and 85 percent complete when [ EX. 4 ] defaulted. Safeco/First National paid losses and expenses of [ EX. 4 ] under these bonds. We questioned SBA's 70-percent guaranteed portion of [ EX. 4 ] for the reasons discussed below.

a. Safeco/First National issued a dual-obligee rider to the performance bond naming [ ex. 4 ] [ ex. 4 ] as an additional obligee. [ ex. 4 ] however, was not a party to the contract between the original obligee and [ ex. 4 ] Title 13, Code of Federal Regulations (CFR) 115.11, Definitions, states that no person shall be named co-obligee on a bond or rider to a bond unless such person is bound by the contract to the principal to the same extent as the original obligee. Title 13, CFR 115.13, Defenses of SBA, states that SBA shall be relieved of all liability under the bond guarantee if the surety names an obligee on the bond who is not bound by the contract to the principal to the same extent as the original obligee. Accordingly, we questioned [ ex. 4 ] SBA's guaranteed share of total losses and expenses paid under the bond ( [ ex. 4 ] x 70%).

b. Safeco/First National incurred legal fees of [ ex. 4 ] to defend itself in a complaint brought by the obligee. The complaint [ ex. 4 ] [ ex. 4 ] The complaint was settled by compromise, [ ex. 4 ] [ ex. 4 ] Title 13, CFR 115.11, states that loss is not to include costs or payments (for example, tort damages) arising out of a successful tort law suit initiated under the bond by a principal or any other person against the surety.

In addition, Safeco/First National did not act prudently in light of its responsibility to mitigate losses. Title 13, CFR 115.62, Qualifications of Surety, states that SBA may suspend the preferred status of a PSB surety, if the surety has not acted prudently in its efforts to minimize losses. Safeco/First National stated in various correspondence to SBA that it elected to respect [ ex. 4 ] assertion that the obligee breached the contract. Further, Safeco/First National stated that it was unable to respond appropriately under the bond, because the obligee would not consider any performance or assistance by Safeco/First National unless [ ex. 4 ] elected to waive its claim against the obligee. As a result, the obligee completed the work and filed the above-mentioned suit against Safeco/First National.

Our review of Safeco/First National's file did not convince us that it could not have remedied the obligee without affecting [ ex. 4 ] ability to pursue its claim against the obligee, in accordance with the contract's provisions for handling disputes. As a result, Safeco/First National incurred expenses and losses of [ ex. 4 ] under a bond with a contract amount of [ ex. 4 ] which was between 65 and 85 percent complete.

For the reasons stated above, we questioned [ ex. 4 ] SBA's guaranteed share of unreasonable attorney fees and loss under the bond [ [ ex. 4 ] x 70% ]. This amount was also questioned in a, above.

c. Safeco/First National financed [ ex. 4 ] of legal expenses in [ ex. 4 ] suit against the obligee. Correspondence in the claim file indicated that amounts paid to [ ex. 4 ] attorneys would be considered advances or loans under the indemnity agreement. The suit resulted in a [ settlement [ F21A ex. 4 ] In this matter, however, Safeco/First National did not act prudently to mitigate its losses [ ex. 4 ] In addition, Safeco/First National's claims-handling policies and procedures require SBA's consent

prior to entering into financing arrangements with any principal. Accordingly, we questioned [ ex. 4 ] SBA's guaranteed share of [ ex. 4 ] legal expenses ([ ex. 4 ] x 70%). This amount was also questioned in a, above.

- d. Safeco/First National paid [ ex. 4 ] in five monthly payments for subsistence expenses. These expenses were not necessary for contract performance and were incurred after [ ex. 4 ] defaulted on the contract. Subsistence expenses are not allowable losses or expenses as defined by Title 13, CFR 115.11(b), (c), or (e). We questioned [ ex. 4 ] SBA's guaranteed share of subsistence expenses ([ ex. 4 ] x 70%). This amount was also questioned in a, above.

**Recommendations:** We recommend that the Associate Administrator, OSG, require Safeco/First National to:

1. Reimburse [ ex. 4 ] of questioned costs to SBA.
2. Revise its underwriting procedures to ensure compliance with SBA's requirements regarding dual obligees.
3. Revise its claims processing policies to ensure compliance with the requirement to minimize losses.

**Safeco/First National Response and Accountants' Additional Comments:** Safeco/First National responded to each of the four findings for [ ex. 4 ] (a through d) in our draft report. We summarize its responses and provide additional comments below.

- a. **Safeco/First National:** Safeco/First National stated that Cotton & Company's interpretation of the regulations is misapplied and that the regulations, the Information Book of the Preferred Surety Bond Program and the Preferred Surety Bond Guarantee Agreement, each allow the PSB surety to issue dual-obligee bonds with the proper language. The dual-obligee bond issued in connection with the [ ex. 4 ] bond contained the savings clause and other protective language and is in compliance with SBA regulations.

**Cotton & Company:** We did not question the fact that Safeco/First National issued a dual-obligee bond or that the bond did not include the proper language. We questioned SBA's liability under the bond, because the co-obligee was not bound by the contract to the same extent as the original obligee, as required by Title 13 CFR 115.11 and 115.13. These costs remain questioned.

- b. **Safeco/First National:** Safeco/First National stated that Cotton & Company's analysis is overly simplistic, because it incorrectly segregates the bad faith claim from all others. The claim arose from a dispute between the obligee and [ ex. 4 ] the obligee subsequently terminated [ ex. 4 ] contract for default. [ ex. 4 ] asserted defenses to the claim and wrongful termination of its contract. Safeco/First National's initial investigation indicated that [ ex. 4 ] defenses appeared reasonable. Safeco/First National, with obligations to both [ ex. 4 ] and the obligee, could not take a position detrimental to either party.

Safeco/First National advised the obligee of the defenses asserted to its claim and of [ ex. 4 ] potential counter claim and arranged for contract completion in a manner that would reserve the rights of both parties. The obligee would not agree to this, insisting [ ex. 4 ] relinquish its

counter claim; the obligee elected to complete the project and file a claim against the performance bond and an additional claim for tortious bad faith. [ FOIA EX. 4 ]  
[ EX. 4 ] Prior to trial, Safeco/First National settled the claim [ EX. 4 ] while preserving [ EX. 4 ] right to pursue its claim. Considerations for the settlement were merits of the obligee's claim (costs to complete the contract were reasonable), ongoing legal costs to defend the lawsuit, and the hostile legal environment [ EX. 4 ]

Safeco/First National stated that it would have settled for a similar amount even if the obligee had not filed a tort claim. Cotton & Company's contention that settlement was not the best course of action is speculative at this point given the facts, the complexity of the case, and the potential for greater defense costs. Safeco/First National handled the claim prudently and fairly and in compliance with the regulations.

**Cotton & Company:** We did not question Safeco/First National's decision to settle when it did, considering the merits of the obligee's claim and mounting legal costs. We questioned the [ EX. 4 ] loss because Title 13 CFR 115.11 does not allow costs or payments (tort damages) arising from a successful tort suit. In addition, we questioned the loss and the legal fees, because Safeco/First National did not act prudently when the principal defaulted. Our review of the file did not convince us that Safeco/First National could not have remedied the obligee without affecting [ EX. 4 ] ability to pursue its claim against the obligee, under the contract's provisions for handling disputes. Safeco/First National's own correspondence to SBA indicated that it was not able to respond appropriately under the bond.

Safeco/First National stated that it would have settled for a similar amount even if the obligee had not filed a tort claim. This statement is not supported and does not appear reasonable given the fact that the [ EX. 4 ] contract was between 65 and 85 percent complete at the time of default. These costs remain questioned.

- c. **Safeco/First National:** Safeco/First National stated that Cotton & Company's position was either an oversimplification or a true misunderstanding of surety law or the claims handling process. It stated that, as a surety, it has the authority to pursue all of [ EX. 4 ] rights, in which case it would have incurred the legal fees questioned in the report. Had Safeco/First National not pursued [ EX. 4 ] claim, it would have been criticized for lack of effort to mitigate its damages. [

[ FOIA EX. 4 ]

After the decision was made to pursue the claim, several developments reduced the value of the claim. Consequently, [ EX. 4 ] accepted a [ EX. 4 ] settlement.

**Cotton & Company:** We found no evidence in the claim file to indicate that Safeco/First National was even considering pursuing [ EX. 4 ] rights. Rather, [ EX. 4 ] requested the loan for legal fees under its indemnity agreement, and Safeco/First National asked its attorney [ EX. 4 ]

FOIA EX. 4

Thus, it does not appear that Safeco/First National's actions constituted typical surety law or claims processing practices.

EX. 4

Thus, if Safeco/First National had incurred legal fees, [ 4 ] would still have been responsible for repayment. These costs remain questioned.

- d. **Safeco/First National:** Safeco/First National stated that the payments made to [ EX. 4 ] were in effect consulting expenses, which would have been incurred had Safeco/First National pursued the claim against the obligee. Had Safeco/First National not provided payments to [ EX. 4 ] [ 4 ] would have sought employment elsewhere. [ EX. 4 ]

**Cotton & Company:** [ EX. 4 ] submitted an itemization of living expenses, which Safeco/First National paid. These included vehicle expenses, utility costs, food, health insurance, cable television, and property tax. [ EX. 4 ] request for an advance indicated that [ EX. 4 ] seeking employment, but was experiencing difficulty obtaining employment. Correspondence did not support Safeco/First National's contention that [ EX. 4 ] was paid consulting fees as compensation for services provided. These costs remain questioned.

FOIA EX. 4

Safeco/First National issued performance and payment bonds to [ EX. 4 ] for [ EX. 4 ] one half of the contract amount, and paid losses and expenses (net of recoveries) of [ EX. 4 ] under these bonds. We questioned SBA's 70-percent guaranteed portion of [ EX. 4 ] [ EX. 4 ] for the reasons discussed below.

- a. Safeco/First National did not assess or remit additional surety and contractor fees to SBA for increases in contract amounts resulting from change orders, or notify SBA of the increased bond liability. Safeco/First National accepted the additional liability and submitted losses to SBA based on completing the entire contract. The contract amount increased by [ EX. 4 ] or 43 percent, as a result of contract change orders. A Safeco/First National representative stated that it did not assess additional fee and premium, because [ 4 ] was in default and would not have been able to pay. The change orders were, however, approved prior to default. The surety bonds stated that the surety waived notice of contract changes; thus, Safeco/First National was not aware of contract increases until after the default.

Title 13, CFR 115.13, states that SBA shall be relieved of all liability under the surety bond guarantee if the surety has substantially violated the SBA regulations in Title 13. Title 13, CFR 115.6(c)(6)(i), Operations, states that the PSB must process bond liability increases within its allocation in the same manner as initial guaranteed bond issuances and present checks for additional fees due from the principal, computed on aggregate increases if they exceed 25 percent or \$50,000, whichever is less.



We questioned [ ex. 4 ] SBA's share of losses and expenses paid under the bond ( [ ex. 4 ] x 70%).

- b. While Safeco/First National recovered remaining contract funds and attempted recovery under its general indemnity agreement, it did not attempt to recover losses under a subordination agreement between [ ex. 4 ] The agreement subordinates the [ ex. 4 ] rights and claims against [ 4 ] to any and all rights of Safeco/First National in relation to a [ 4 ] debt to [ ex. 4 ] In an interoffice memorandum, a Safeco/First National representative stated that the loan to [ ex. 4 ] was repaid even though Safeco/First National had a subordination agreement.

The subordination agreement states that Safeco/First National's loss is to be paid in full out of [ ex. 4 ] assets before any payment on account of the indebtedness is made or realized by the creditor [ ex. 4 ]. In addition, the agreement states that, in the event of a breach of any subordination agreement terms, the creditor agrees to hold all funds and the value of any property and benefit received in trust for the benefit of Safeco/First National and pay Safeco/First National on demand for reimbursement of its losses. Further, the creditor agrees to compensate Safeco/First National for any damage, in the form of loss or otherwise, caused or contributed by the breach.

We did not find evidence that Safeco/First National pursued its recourse under the subordination agreement. Accordingly, we questioned [ ex. 4 ] SBA's guaranteed share of amounts that should have been recovered under the subordination agreement ( [ ex. 4 ] x 70%). This amount was also questioned in a, above.

**Recommendations:** We recommend that Associate Administrator, OSG, require Safeco/First National to:

1. Reimburse [ ex. 4 ] of questioned costs to SBA.
2. Revise its claims processing policies and procedures to ensure that all sources of recovery are pursued.
3. Revise its underwriting policies and procedures to ensure that it is aware of all contract modifications, so Safeco/First National can remit additional premium and fees to SBA, when required by regulation.

**Safeco/First National Response and Accountants' Additional Comments:** Safeco/First National responded to the two findings for [ ex. 4 ] (a and b) in our draft report. We summarize its responses and provide additional comments below.

- a. **Safeco/First National:** Safeco/First National stated that the waiver of notice of contract changes is fairly standard language in bond forms, and case law has provided the surety with defenses when there is a gross contract increase without surety consent. It agreed that the increase exceeded SBA parameters and stated that, by the time Safeco/First National became aware of the increase, [ ex. 4 ] was in claim status. Safeco/First National could have billed [ 4 ] for additional premium and fees; due to [ 4 ] insolvency, however, the costs would have been added to the loss and in turn increased SBA's liability. It would be unproductive to

pursue premium and fees in this situation; if SBA insists, however, Safeco/First National can process the fees and related loss on the next bordereau.

**Cotton & Company:** The change orders were approved before [ ex. 4 ] default, and thus, Safeco/First National should have assessed additional premium and fees when approved—before the default. Further, unpaid premium and fees are not losses or expenses under either the performance or payment bonds and therefore are not part of SBA's guarantee liability. These costs remain questioned.

- b. **Safeco/First National:** Safeco/First National stated that a memorandum in the claim file related a rumor that [ ex. 4 ] had repaid [ ex. 4 ] in breach of the subordination agreement; there was no evidence, however, [ ex. 4 ] repaid the loan. The cost of pursuing such an unclear claim would have exceeded any potential recovery; thus, Safeco/First National did not pursue the matter further. This course of action served as reasonable mitigation to the costs involved in the case.

**Cotton & Company:** The correspondence referred to in the audit report stated "as it turns out the money was repaid and we have limited recourse against the lenders [ ex. 4 ]". Safeco/First National did not provide evidence that the loan was not repaid. In addition, it did not provide documentation supporting efforts to pursue recourse against [ ex. 4 ] or that the cost of pursuing recourse would exceed the [ ex. 4 ] subordinated debt. These costs remain questioned.

[ FOIA ex. 4 ]

Safeco/First National issued a subcontractor performance bond to [ ex. 4 ] [ ex. 4 ] the contract amount. Safeco/First National paid losses and expenses of [ ex. 4 ] and claimed SBA's share of [ ex. 4 ] for reimbursement as of April 30, 1998. We questioned SBA's 70-percent guaranteed portion of [ ex. 4 ] for the reasons discussed below.

- a. Safeco/First National executed the bond after work had begun under the contract. Both a consultant's report and an attorney's letter stated that work under the contract was started in March [ 4 ] The bond was executed on April 16, [ 4 ] Title 13, CFR 115.64, Timeliness Requirement, states that a bond cannot be executed or approved by a PSB surety after commencement of contract work, unless the surety obtains written SBA approval by submitting a Surety Bond Guarantee Agreement Addendum (SBA Form 991), together with the evidence and certifications described in CFR 115.19(f)(1)(ii). Safeco/First National did not submit the required form or obtain SBA's approval. As a result, SBA guaranteed an ineligible bond. We questioned [ ex. 4 ] SBA's guaranteed share of expenses claimed for reimbursement under the bond ([ ex. 4 ] x 70%).
- b. Safeco/First National made payments to [ ex. 4 ] vice president for assistance in validating claims under the bond. As of April 30, 1998, [ ex. 4 ] had been paid. The general indemnity agreement between Safeco/First National and [ ex. 4 ] states that [ ex. 4 ] agrees to pay all loss, costs, and expenses of any kind or nature incurred by Safeco/First National by reason of having executed the bond. Therefore, it is not reasonable for Safeco/First National to pay [ ex. 4 ] vice president costs for which [ ex. 4 ] is liable under the indemnity agreement. We questioned [ 4 ] SBA's guaranteed share of costs paid to the vice president ([ ex. 4 ] x 70%). This amount was also questioned in a, above.

**Recommendations:** We recommend that the Associate Administrator, OSG:

1. Require Safeco/First National to reimburse SBA questioned costs of [ ex.4 ] To date, Safeco/First National remitted [ ex.4 ] to SBA related to this finding.
2. Deny any future liability under this bond.

**Safeco/First National Response and Accountants' Additional Comments:** Safeco/First National submitted one response to the two findings for [ ex.4 ] (a and b) in our draft report. We summarize its response and provide additional comments below.

**Safeco/First National:** Safeco/First National was unaware that work had actually begun under the contract prior to issuing the bond, but the facts of the matter now seem clear. Accordingly, Safeco/First National has returned all funds it received to date from SBA. Discrepancies between Safeco/First National's and SBA's records are the result of processing difficulties in the SBA system or checks issued by SBA that have not been received by Safeco/First National.

**Cotton & Company:** As of April 30, 1998, SBA had reimbursed Safeco/First National [ ex.4 ] Accordingly, Safeco/First National should reimburse SBA an additional [ ex.4 ]

### Aggregation of Contracts Exceeding Statutory Ceiling

Safeco/First National issued bonds for two contracts aggregating more than \$1.25 million; the aggregated contracts were with the same principal and obligee, and work was performed in the same general location. The project descriptions for the two contracts were:

- Construction of the [ FOIA ex.4 ]
- Construction of the [ FOIA ex.4 ]

Title 13, CFR 115.11 (1994 regulations), states that the amount of the contract to be bonded must not exceed \$1,250,000 in face value at the time of the bond's execution. The amounts of two or more contracts for a "single project" should be aggregated to determine the contract amount, unless the contracts are to be performed in phases and the prior bond is released before the beginning of each succeeding phase. A "single project" means one represented by two or more contracts with one principal or its affiliates and one obligee or its affiliates for performance at the same location, regardless of job title or nature of the work to be performed.

We questioned the eligibility of the following bonds to [ ex.4 ] As of June 16, 1998, no claims had been paid under the bonds.

<u>Bond No.</u>	<u>Amount</u>
[ ex.4 ]	[ ex.4 ]
Total	[ ex.4 ]

**Recommendations:** We recommend that the Associate Administrator, OSG:

1. Deny liability for these bonds if they have either not yet been closed or the warranty periods have not expired and claims are filed in the future.
2. Require Safeco/First National to implement policies and procedures to ensure bonds are not issued for multiple contracts exceeding \$1.25 million, if the contracts constitute a single project.

**Safeco/First National Response and Accountants' Additional Comments:** Safeco/First National responded to the finding in our draft report. We summarize its response and provide additional comments below.

**Safeco/First National:** Safeco/First National stated that this issue appears to be a matter of interpretation of "single project" and the intention of the regulations. It cited three situations that it considers to comply with SBA regulations:

- A state highway department typically bids multiple projects on the same day, including several projects for work on the same road.
- A large project is often bid as multiple smaller projects to encourage local contractor participation and increase bidding competition.
- Many owners let work on an ongoing basis for maintenance and improvement projects.

Safeco/First National contends that in each of these cases the work is distinct, intentions are honorable, and projects comply with SBA regulations. Safeco/First National stated that such is the case with the [ *FOIA EX. 4* ] work; thus, it would be an improper interpretation of the regulations to deny the SBA guarantee on these or similar bonds.

**Cotton & Company:** We do not consider the situations cited by Safeco/First National to comply with SBA's regulations. In the cited situations, the contracts should be aggregated to determine if the maximum \$1,250,000 contract amount is exceeded. We recommend that SBA legal counsel make a determination regarding this matter.

### **Underwriting File Documentation**

Safeco/First National did not always maintain the required underwriting documents in its underwriting files. While the files contained copies of the bonds and contracts, they generally were not signed copies. In addition, most of the underwriting files did not contain evidence of the power-of-attorney.

Title 13, CFR 115.21(b), Records (1996 regulations), states that a surety must maintain the records listed for the term of each bond, plus additional time required to settle surety claims for reimbursement from SBA and to attempt salvage or other recovery, plus an additional 3 years. Further, if unresolved audit findings in relation to a particular bond exist, the surety must maintain the related records until the findings are resolved. The records to be maintained include:

- A copy of the bond.
- A copy of the contract.
- All documentation submitted by a principal in applying for the bond.
- All information gathered by the surety in reviewing a principal's application.
- All documentation of any of the events set forth in CFR 115.35(a) or 115.65(c)(2).

Safeco/First National stated that it does not usually keep a signed copy of a bond, contract, or documented power-of-attorney in the underwriting file; it can, however, obtain signed copies when necessary. Signed documents are essential to support adequate and proper underwriting and for processing claims and thus should be included in Safeco/First National's files. We were able to obtain executed copies of documents when necessary and thus did not question any costs related to this matter.

**Recommendations:** We recommend that Safeco/First National maintain signed copies of bonds, contracts, and power-of-attorney letters in the underwriting files for all current and future SBA guaranteed bonds.

**Safeco/First National Response and Accountants' Additional Comments:** Safeco/First National responded to the finding in our draft report. We summarize its response and provide additional comments below.

**Safeco/First National:** Safeco/First National stated that the regulations require copies of the bond and the contract in the files, and it has retained such documentation. Cotton & Company recommended that the documentation be signed, which is not specifically called for in the regulations and is impractical in today's business environment. When necessary, Safeco/First National is able to obtain signed copies from the obligee. Safeco/First National is confident that its documentation procedures comply with SBA regulations and does not feel any changes are warranted.

**Cotton & Company:** For the reasons cited in the audit report, we think Safeco/First National's files should contain signed and executed copies of bonds and contracts as well as documentation of the power of attorney.

## MANAGEMENT CONTROLS

The scope of our audit did not include assessing management controls, and thus we did not identify or test such controls.

## SBA MANAGEMENT'S RESPONSE

The Associate Administrator, OSG, reviewed the draft report of the performance audit of Safeco/First National, Safeco/First National's reply, and Cotton & Company's additional comments and stated that the auditors' recommendations appear to have merit. Because the issues surrounding the [ FOIA EX. 4 ] cases are complex and require interpretation of regulations and

procedures, additional information is needed and legal advice may be required before OSG can conclude its review of the report and recommendations. OSG will implement these recommendations upon completion of its review, as appropriate.

COTTON & COMPANY, LLP

By: Catherine L. Nocera  
Catherine L. Nocera, CPA

## SAMPLE BONDS

Sample No.	Preferred Surety Bond Guarantee No.	Safeco/First National Bond No.	Contractor Name	Bond Approval Date	Bond Default Date
1	┌				┐
2					
3					
4		FOIA EX 4			
5					
6					
7	└				┘

\* No claims had been paid under this sample bonds; thus, we only tested them for compliance with SBA's underwriting and fee requirements.

**APPENDIX**

**SAFECO/FIRST NATIONAL RESPONSE TO THE DRAFT REPORT**



**FIRST NATIONAL SURETY**

SAFECO INSURANCE COMPANIES  
 SURETY DEPARTMENT (T-8)  
 SAFECO Plaza  
 Seattle, WA 98185

TELEPHONE (206) 545-5412  
 FAX (206) 545-5664

RECEIVED  
 SEP 15 8 07 AM '99

OFFICE OF SURETY  
 GUARANTEES

September 9, 1998

Mr. Robert J. Moffitt  
 Associate Administrator, Office of Surety Guarantees  
 U.S. Small Business Administration  
 409 Third Street, SW, Suite 8600  
 Washington, D.C. 20416

Dear Mr. Moffitt:

Re: SBA draft audit report

I appreciate the opportunity to review a copy of the draft findings that resulted from the audit conducted in our office in June of this year. Hopefully, with this type of open communication we can address any differences in opinion and come to a reasoned determination on the issues at hand.

The first thing that comes to my attention in reviewing the audit report is that the scope of the audit involved a very small number of bonds. The general conclusions that were reached were not very favorable and the context of the report failed to acknowledge the hundreds of things that we have done right since entering the program back in 1992. However, I am confident that you recognize our positive contributions to the Preferred Surety Bond program.

The audit results and recommendations covered bonds for the [ EX. 4 ] accounts, as well as, discussing the issues of the aggregation of contracts and underwriting file documentation. I will attempt to be brief, but will offer a response to each of these five issues.

[ FOIA EX. 4 ]

- Dual-obligee rider

The auditor's interpretation of the regulations is misapplied in this situation. The regulations, the Information Book of the Preferred Surety Bond Program and the U. S. Small Business Administration Preferred Surety Bond Guarantee Agreement all allow for the PSB surety to issue dual-obligee bonds with the proper language. The dual-obligee bond that was issued in connection with [ EX. 4 ] bond contained the savings clause and other protective language and is in compliance with the SBA regulations. Accordingly, this is not a basis for questioning coverage of the SBA guarantee.

- Legal fees of [ EX. 4 ]

The auditor's analysis here is overly simplistic, as it incorrectly segregated out one claim against First National, the bad faith claim, from all the others. Claims matters are often complex and the situation tends to be fluid. Targeting one issue after the fact to establish a basis for the denial of the SBA guarantee does a disservice to the facts of the case, as well as, to the spirit and letter of the regulations that grant underwriting and claims handling authority to the PSB sureties.

The claim in this case arose from a dispute between the obligee, [ EX. 4 ] [ EX. 4 ] and with the contractor [ 4 ]. Eventually, [ 4 ] was defaulted by the obligee and its contract was terminated. [ 4 ] asserted defenses to the claim against its bond and claimed the termination of its contract was wrongful. Our initial investigation indicated the defenses raised by [ EX. 4 ] appeared reasonable. It is important to point out that as a surety we have obligations to both our principal and the obligee. When there exists a bona fide dispute between the principal and

FOIA EX. 4 + 6

obligee the surety cannot take a position that is detrimental to one party over the other. If it did, then the surety would potentially be subject to the claim of the injured party.

In this situation we advised the obligee of the defenses asserted to its claim and the potential counter-claim [ EX. 4 ] None-the-less we attempted to arrange for completion of the project in such a way as to allow both obligee and principal to reserve their respective rights. The obligee would not agree to this as they insisted that [ 4 ] relinquish its counter-claim. Instead the obligee elected to complete the project and file a complaint against the performance bond and an additional claim for tortious bad faith. [ EX. 4 ] Prior to going to trial we settled with the obligee for [ 4 ] while reserving [ 4 ] right to pursue an affirmative claim.

The considerations for this settlement were:

1. Merits of obligee's claim. A reasonable cost to complete the project.
2. Ongoing cost of defense of lawsuit.
3. Hostile legal environment. [ EX. 4 ]

Had the obligee never filed a tort claim against us we still would have settled for a similar amount. The contention by the auditors that settlement was not the best course of action given the facts, the complexities of the case and the potential for greater defense costs is speculation at this point. First National handled the claim in a prudent and fair manner and in compliance with the regulations.

In light of these facts we feel that the [ 4 ] in legal fees are allowable. No funds are then due to be returned to the SBA.

• Legal fees of [ EX. 4 ]

Again, the position taken by the auditors is an over simplification or a true misunderstanding of either surety law or of the claims-handling process. As a surety in a situation like this we have the right to step into the principal's shoes and through subrogation pursue all of their rights. Had we elected to do that First National would have incurred the above legal fees in filing suit against the obligee. Either way, there was going to be a cost to pursuing a claim against the obligee. I wish to point out that had we not taken any action to pursue this claim we would likely have received criticism from the SBA for our lack of effort to mitigate our damages. The SBA can't have it both ways.

[ FOIA EX. 4 ]  
[ FOIA EX. 4 ]

Furthermore, contrary to the auditor's assertion, the SBA regulations grant to the PSB surety the authority to manage and settle claims and losses without prior approval of the SBA and as a result our actions were in compliance with our procedures and with the regulations.

Subsequent to this decision being made several developments reduced the value of this claim. First, the economic condition [ EX. 4 ] changed [ ]

[ EX. 4 ]

Second, [ EX. 4 ]  
[ ] Consequently we accepted [ EX. 4 ] as settlement.

In light of these facts we feel that the [ ex.4 ] in legal fees are allowable. No funds are then due to be returned to the SBA.

- Subsistence support of [ Ex.4 ]

Had we elected to pursue the claim against the obligee ourselves we would have had to retain a consultant to prepare and pursue the claim. The cost of this consultant would very likely have been far in excess of [ ex.4 ] But, given the reasons articulated above we elected to have [ 4 ] pursue this claim. The payments made to [ ex.4 ] were, in effect, consulting expenses. As [ ex.4 ] had no other livelihood, had we not reached this arrangement [ 4 ] would have had to seek employment elsewhere. We felt it was in our interest to have [ 4 ] undivided attention while this claim was being prepared and pursued.

In light of these facts we feel that the [ ex.4 ] in expenses are allowable. No funds are then due to be returned to the SBA.

[ FOIA EX.4 ]

- Remittance of additional fees due to an increase in the contract price.

The auditors seem to have a few issues here. These include the waiver of notice by the surety of changes to the contract and the non-payment of additional fees due to an increase in the contract amount.

The waiver of notice to changes in the contract has become fairly standard language in bond forms over the years and this provision is found in many public and private bond forms. Case law has provided the surety with defenses when there is a gross increase in the contract price without consulting with and receiving the consent from the surety. In this case the initial contract was relatively small, so a nominal increase could be perceived as being material and the actual increase did exceed the 25% or \$50,000 SBA parameters. However, by the time we became aware of the increase the contractor was already in claim and ultimately became a loss. At this juncture we could have billed the contractor for increases in the premium and SBA contractor fees, but due to the insolvency of the contractor these costs would simply be added to the loss and in turn increase the SBA's liability. It would seem unproductive to pursue premiums and fees in this type of situation, but if the SBA insists upon an accounting for these items, then we can process the fees and the related loss in via the next bordereau.

- Recovery efforts relative to the subordinated debt

The auditor's assert that First National failed to pursue its rights under a subordination agreement relating to a loan from [ ex.4 ] You will recall prior to writing any bond for this contractor we asked for, and obtained, a subordination of the rights of [ ex.4 ] under a loan agreement. There is a memo in the file from a first National underwriter relating a rumor that [ ex.4 ] had repaid [ ex.4 ] in breach of our subordination agreement. However, there was no evidence that [ ex.4 ] had repaid the loan, it was merely hearsay and rumor. In addition the cost of pursuing such an unclear claim would likely have exceeded any potential recovery. Based on this we decided not to "throw good money after bad" and did not pursue the matter further. This course of action served as a reasonable mitigation to the costs involved in this case.

In light of these facts the [ ex.4 ] in costs are allowable. No funds are then due to be returned to the SBA.

[ FOIA EX.4 ]

The auditors determined via a claims consultant report that work had actually begun on this contract before the bond was issued and that the SBA form 991 had not been completed and forwarded to the SBA for approval. First National did not know this situation at the time of writing the bond, but the facts of the matter now seem clear. Accordingly, we have already returned all of the funds that we've

received to date from the SBA relative to this loss. Any discrepancy in amounts between our records and the SBA's records are due to processing difficulties in the SBA system or due to checks issued by the SBA that have not been received by First National.

#### Aggregation of Contracts Exceeding Statutory Ceiling

The auditors cite Title 13 CFR 115.11, Definitions with respect to work performed for an obligee under a "single project". The issue here appears to be a matter of interpretation and the intention of the regulations.

The concern is that a principal and an obligee will split up a specific project into smaller pieces in order to circumvent the SBA bond size limitation of \$1,250,000. In doing so the work may actually proceed concurrently and as a result the real risk to the project, the contractor, the surety and the SBA is in an amount that exceeds the size limit and would make these bonds ineligible for the SBA guarantee.

The above scenario needs to be contrasted to several legitimate situations. A state highway department typically bids multiple projects on the same day often including several projects that call for work on the same road. Large public and private owners often have sizeable capital improvement programs that are bid out at or near the same time in multiple, smaller jobs, in order to encourage local contractor participation and to increase bidding competition. Many owners let work on an ongoing basis for ongoing maintenance and improvements to their site and facilities. In each of these cases the work is distinct, the intentions are honorable and they are all in compliance with the SBA regulations. Such is the case of the [ FOIA EX. 4 ]

While there is no claim or loss experienced or anticipated on these bonds, it would be an improper interpretation of the regulations to deny the SBA guarantee on these or similar bonds provided for other customers.

#### Underwriting File Documentation

The auditors are again making an extreme interpretation of the regulations. The regulations call for copies of the bond and the contract. We have retained such documentation in our files. The difference is that the auditors are recommending that this documentation be copies of the signed bonds, contracts and powers of attorney. While this recommendation may be ideal, this requirement isn't specifically called for in the regulations and it is simply an impractical ideal in today's business environment. It is a challenge enough to get any copy of this information, let alone copies of the signed documents. If it becomes necessary to review the signed paperwork, i.e., in a claims situation, then we are able to obtain copies from the obligee. We are confident that our documentation procedures are in compliance with the SBA regulations and do not feel that any changes are warranted.

#### Summary

It is our opinion that based upon the regulations and the facts at hand that the costs associated with the [ EX. 4 ] losses are legitimate and allowable under the SBA regulations. As such, we do not feel that any of the recommended refunds are due to the SBA. We do, however, acknowledge the inadvertent situation with [ EX. 4 ] and we have already rectified that matter. The issues of contract aggregation and file documentation appear to be misinterpretations of the regulations by the auditors and we feel that our current handling procedures are in compliance with the SBA guidelines.

I, again, thank you for the opportunity to clarify the issues raised in the draft audit report. If you have any questions, or would like to discuss these matters further, then please feel free to give me a call.

Respectfully,



Kenneth M. Koch  
Underwriting Manager

FOIA EX. 4+6

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FOIA EX. 6