NATIONAL ASSOCATION OF SURETY BOND PRODUCERS

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Committee on Small Business
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On

Construction Contracting: Barriers to Small Business Participation

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The National Association of Surety Bond Producers (NASBP) is a national trade organization of professional surety bond producers, whose membership includes firms employing licensed surety bond producers placing bid, performance, and payment bonds throughout the United States and its territories. NASBP wishes to extend its appreciation to Chairman Mulvaney, Ranking Member Chu, and to the members of the Subcommittee on Contracting and Workforce of the U.S. House of Representatives' Committee on Small Business for the opportunity to provide written and oral testimony on issues of importance to federal contracting opportunities for small businesses. Our testimony will center on policy issues which, in our opinion, will provide greater protection to and resources and opportunities for small construction firms.

By way of background, our testimony will begin with a brief description of the important role surety bonds play in the federal procurement arena.

The Importance of Surety Bonds: Sound Public Policy

Corporate surety bonds are three-party contract agreements by which one party (a surety company) guarantees or promises a second party (the obligee/federal government) the successful performance of an obligation by a third party (the principal/contractor). In deciding to grant surety credit, the surety underwriter conducts in-depth analysis, also known as prequalification, of the capital, capacity and character of the construction firm during the underwriting process to determine the contractor's ability to fulfill contractual commitments. *Surety bonds are an essential means to discern qualified construction companies and to guarantee contracts and payments, ensuring that vital public projects are completed, subcontracting entities are paid, and jobs are preserved.*

The federal government has relied on surety bonds for prequalification of construction contractors and for performance and payment assurances since the late nineteenth century. In 1894, the U.S. Congress passed the Heard Act which codified the requirement for surety on U.S. government contracts and institutionalized the business of surety. In 1935, the Heard Act was superseded by the Miller Act, which required the continuation of these vital assurances so that U.S. taxpayer funds were protected and subcontractors and suppliers would receive payment for their labor and materials. Today, the Miller Act and applicable regulations require that, before any contract exceeding $150,000 is awarded for a federal construction contract, the prime contractor must furnish a performance bond and a payment bond to the contracting agency.

Types of Surety Bonds

The bid bond assures that the bid has been submitted in good faith and the contractor will enter into the contract at the bid price and provide the required performance and payment bonds. A performance bond protects the project owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. The payment bond protects subcontractors and suppliers, which do not have direct contractual agreements with the public owner and which would be unable to recover lost wages or expenses should the contractor be unable to pay its financial obligations. Often, small construction businesses must access the federal procurement marketplace at subcontractor and supplier levels, and the payment bond is their primary recourse and protection in the event of prime contractor nonpayment or insolvency.

Role of the Bond Producer

The bond producer plays a vital role in the federal construction process. The bond producer stands as the "bridge" between the construction contractor and the surety company. The bond producer works closely with the construction business as an advisor, educator, and match maker to position the business to meet underwriting requirements in order to obtain surety credit.

The objective of the producer is not only to assist the contractor with obtaining surety credit for each contract requiring surety credit but to ensure that the contractor's business remains viable and thrives for years to come. To that end, bond producers assist construction firms of all sizes with creating networks of knowledgeable professional services providers, such as construction attorneys, certified public accountants familiar with construction business practices, and construction lenders, and may assist construction firms with market intelligence and even strategic and succession planning.

Assist Small Businesses: Enhance the U.S. Small Business Administration's (SBA) Bond Guarantee Program

The SBA Bond Guarantee Program (Program) was created to ensure that small and emerging contractors, which, for various reasons, do not qualify in the standard surety market, have a means by which to gain access to surety credit. The Program provides guarantees, ranging from 70 to 90 percent, to participating surety companies as an inducement to extend surety credit to these construction firms. The construction firm and the surety company pay fees to access the Program.

The Program has been serving small businesses for decades and continues to be a necessary and needed federal program. In recent years, the SBA has undertaken incremental efforts to improve the functioning and the appeal of the Program, making strides, for example, in improving its application processes and procedures, its response time to claims, and expanding the Program's reach to include design-build contracts. NASBP applauds the SBA for taking these important steps. In the opinion of NASBP, however, much more can and needs to be done so the Program can fully realize its potential to assist small businesses. The SBA Bond Guarantee Program is an example of a good federal program that deserves to get better to continue to achieve its mission.

Legislative and Regulatory Enhancements
NASBP offers recommendations for enhancements to the Program below.

- Increase the SBA guarantees to sureties across the board to 95% of the bond amount for 18 months, then reduce the guarantee across the board to 90% thereafter.
- Increase the size of contracts that can be guaranteed through the Program to $5 million; the contract threshold currently is $2 million.
- Provide statutory discretion to the Administrator to determine liabilities assumed by the Program, so that a denial of a guarantee can be partial, reflecting the amount of the prejudice suffered by the SBA, and not a complete denial of the entire guarantee in every instance.
- Require the Administrator to reduce or waive fees paid by contractors and sureties in the Bond Guarantee Program for 18 months, with authority to extend the time period for such actions.
- Provide assistance to small construction firms, particularly to women-, minority- and veteran-owned construction firms, for the purpose of providing them financial means/incentives to access professional services providers such as construction lawyers and construction accountants.
- Create a system of due process in connection with the SBA Bond Guarantee Program so that sureties receive notice, a hearing, and right to appeal if: 1) the SBA denies a surety’s request to participate in the Program or eliminates a surety from the Program, or 2) denies a claim under a bond that the SBA has guaranteed.
- Require the SBA to track the contractors that participate in the program.
- Ensure that the SBA Bond Guarantee Program regulations keep pace with changes in law and practice in the construction and surety industries.
- Ensure that the Program has adequate resources to market itself to small construction businesses and to state and local agencies assisting such businesses.

NASBP supported the enhancements to the Program adopted under the American Recovery and Reinvestment Act (ARRA), which included increasing the contract size that can be guaranteed through the Program from $2 million to $5 million, and up to $10 million if a federal agency’s contracting officer certifies that the guarantee is necessary, and vesting discretion in the Administrator to determine the Program’s liabilities. These enhancements expired on September 30, 2010. NASBP believes that they should be made permanent.

Construction firms, particularly those that are small and emerging, still face an exceedingly difficult construction market for the foreseeable future. Reducing the fees paid by contractors to access the Program and providing assistance with retaining professional services providers would be significant steps to position these businesses to qualify for surety and financial credit. Such enhancements could be taken on a limited time basis to help small construction firms weather the current, difficult economic environment, boosting this particularly hard-hit industry.

Other proposed enhancements are for the purpose of removing barriers to surety company participation in the Program. The Program should offer a uniformly high guarantee percentage that makes business sense to surety companies. Without such a high guarantee, such as 90%, surety companies will be hard pressed to make the internal business case for underwriting firms that otherwise do not qualify for surety credit. Further, the Program's existing regulations are out of step with prevailing practices of the construction and surety industries. Current SBA regulations, for example, require notice to the SBA from the surety company of change orders exceeding a certain dollar amount or percentage of the contract amount, but most construction contracts, including commonly used standardized forms, such as those published by the American Institute of Architects and by ConsensusDOCS, include boilerplate language requiring the surety to waive notice of increases in contract amount. As a result, sureties routinely are not informed of all contract increases and are not in position to provide the SBA with notice of all changes in the contract amount. The failure to inform the SBA of such changes constitutes grounds for the complete denial of the surety's guarantee. Moreover, the Program does not include a structured process for surety companies to contest the denial of a previously-approved guarantee. At the very least, surety company participants should have a delineated means by which to have their concerns or positions heard by the Program.

NASBP believes that the proposed enhancements to the Program would create additional opportunities for small and emerging contractors and additional incentives for more sureties and agents to assist small contractors in obtaining their first bonds and graduate them from the SBA Surety Bond Guarantee Program into the traditional surety market.

Educate Small Businesses: Encourage Industry & Government Partnership on Bonding Awareness & Education

Industry and government can work together to provide small and, particularly, emerging construction firms with bonding awareness and education. Many such firms simply do not understand the resources that presently exist for them at the federal level. Also, state and local governments often are unaware of federal programs for emerging construction businesses, such as the SBA Bond Guarantee Program, and may seek to create duplicative and unnecessary programs. NASBP urges that Congress make building such awareness a policy goal of the federal government.

In recent years, NASBP together with the Surety & Fidelity Association of America (SFAA) and in partnership with federal agencies, such as the U.S. Department of Transportation, and with various state and local agencies have been engaged in bonding education programming for small and emerging construction businesses throughout the United States. This past year, NASBP producers worked with SFAA and the U.S. Department of Transportation at eleven bonding education programs throughout the country. An equal number of programs are planned for 2012. These programs, first developed by SFAA, can vary in duration, but typically are offered over the course of eight to ten weeks, acquainting small and emerging construction firms with the business and risk management processes needed for their success and growth and acquainting them with the prerequisites for obtaining surety credit. Subject matter experts drawn from the local construction and surety communities serve as volunteer instructors, providing attendees often with first contacts to important resources for their businesses. Programs like these need to be a component of the outreach efforts of other federal contracting agencies. NASBP would like to assist federal contracting agencies interested in pursuing these awareness and education programs.

Protect Small Businesses: Support H.R. 3534, the Security in Bonding Act of 2011

NASBP strongly supports H.R. 3534, the “Security in Bonding Act of 2011” as a critical means to protect small businesses and to assure the integrity of surety bonds on federal contracts when issued by individuals using a pledge of assets. As noted earlier, the Federal Miller Act requires contractors to furnish surety bonds on federal construction projects to ensure that bonded contracts will be completed in the event of a contractor default, thereby protecting precious U.S. taxpayer dollars and subcontractors and suppliers, many of which are small businesses. The financial stability of the surety is the key to the success of the surety bonding system.

Presently, there are three methods construction firms may use to furnish security on a federal construction project:

1. By securing a bond written by a corporate surety, that is vetted, approved, and audited by the U.S. Department of Treasury and listed in its Circular 570;
2. By using their own assets to post an “eligible obligation,” i.e. a U.S.-backed security, in lieu of a surety bond. The security is pledged directly and deposited with the federal government until the contract is complete; or
3. By securing a bond from an individual, if the bond is secured by an “acceptable asset,” which includes stocks, bonds, and real property.

It is this third alternative that has proven consistently problematic, to the financial detriment of contracting authorities and of subcontractors and suppliers. NASBP believes that the current regulations pertaining to use of individual sureties on federal construction projects are flawed and allow gamesmanship by unscrupulous persons acting as sureties and, therefore, need to be superseded by the statutory approach delineated in H.R. 3534.

Federal Acquisition Regulation (FAR) 28.203-2(b)(3) permits federal contracting officers to accept bonds from natural persons, not companies, if the bond is secured by an “acceptable asset,” which includes stocks, bonds, and real property. These individuals neither are subject to the same scrutiny and vetting given to corporate sureties nor are they required to provide physical custody of the asset to the government that they pledge to secure their bonds to the contracting authority.

This lack of thorough scrutiny of individual sureties and control over their pledged assets has resulted in a number of documented situations where assets pledged by individual sureties have proven to be illusory or insufficient, causing significant financial harm to the federal government, to taxpayers, and to subcontractors and suppliers, many of whom are small businesses wholly reliant on the protections of payment bonds to safeguard their businesses.

Federal requirements do mandate a level of documentation and information from individual sureties. Individual sureties are required to complete, sign, and have notarized an affidavit of individual surety (SF 28), which is a standardized form for the purpose of eliciting a description of the assets pledged and the contracts on which they are pledged. SF 28, however, does not elicit other pertinent information, such as that about the character or fitness of the individual acting as surety, like criminal convictions, state insurance commissioner cease and desist orders, or personal bankruptcies.

Under FAR requirements, the pledged assets also are supposed to be placed in an escrow arrangement by the individual surety, subject to the approval of the contracting officer. The individual surety, however, is not required to turn the assets over to the physical custody of the contracting authority. Each contracting officer, not the Department of Treasury, shoulders the entire burden of determining the acceptability of the individual surety, its documentation, the escrow or security arrangement, and the value and adequacy of pledged assets, and must do so in relatively short order to progress the contract procurement. A missed, incorrect, or forsaken step may mean the acceptance of a fraudulent or insufficient bond, rendering its apparent and much needed protection worthless.

This burden of assessing individual sureties is added to the already considerable responsibilities of contracting officers. They are required to determine the authenticity of the documentation of the assets pledged to support the individual surety's bond obligations and to verify that the pledged assets actually exist, are sufficient, and are available to the federal government. They have to know that a particular financial document is what it purports to be and to understand and to assess the different types of collateral, such as stocks and real estate located anywhere in the United States.

It is not clear if and how often federal contracting officers receive specific training to understand and to perform the needed tasks of examination concerning individual sureties. Documents of federal agencies suggest that there are occasions when federal contracting officers may not have a complete understanding of what is required of them to safeguard taxpayers and small businesses from individual surety fraud. The Financial Management Service of the U.S. Department of Treasury issued a "Special Informational Notice to All Bond-Approving (Contracting) Officers" on February 3, 2006, still posted on the web site for the Financial Management Service at http://www.fms.treas.gov/c570/special_notice.pdf. This informational notice was directed to federal contracting officers to remind them of the applicable FAR requirements governing individual sureties. Specifically, the notice, a copy of which is attached to this testimony, states in part:

"Although FMS is not substantively responsible for approving individual sureties, we believe it prudent to issue this Special Informational Notice on a FYI basis to Agency Bond-Approving (Contracting) Officers who do have that responsibility under the FAR.

Recently, FMS has been made aware of instances where individual sureties are listing corporate debenture notes and other questionable assets on their 'Affidavit of Individual Surety', Standard Form 28. In some instances, the individual sureties used a form other than the Standard Form 28 as their affidavit."

Likewise, the U.S. Department of the Interior issued a notice to its contracting officers in 2009 to remind them of FAR requirements associated with acceptance of individual surety bonds. This notice, titled "Department of the Interior Acquisition Policy Release (DIAPR) 2009-15," states that the Department of the Interior Office of Inspector General conducted an investigation of contracting personnel practices concerning individual sureties and found concerns. Specifically, the release, a copy of which is attached to this testimony, states in part:

"The investigation identified several areas of concern that require our attention. There is concern that Contracting Officers (COs) are: (1) unfamiliar with the FAR requirements for individual surety; (2) accepting individual surety bonds without knowing or verifying the assets backing the bonds; (3) not vetting questions about individual surety bonds through the DOI Office of the Solicitor; and (4) not verifying individual sureties against the General Services Administration's Excluded Parties List System."

If a contracting officer fails to perform adequately the necessary investigation of an individual surety, and the individual surety pledges assets that do not exist, are insufficient, or are not readily convertible into cash to pay the obligations of the defaulted general contractor, everyone on the project from the contracting agency on down is left unprotected and at risk for financial loss. If the assets pledged to support the bonds are uncollectible, unpaid subcontractors and suppliers protected by the bond will suffer financial hardship and could, in turn, default and go into bankruptcy.

Improper Individual Surety Activity

Recent situations illustrate where individual surety bond assets have turned out to be inadequate, illusory, or unacceptable. One illustration is *United States ex rel. JBlanco Enterprises Inc. v. ABBA Bonding, Inc,* where, in spite of a March 11, 2005 cease-and-desist order from the Alabama Insurance Department, Mr. Morris Sears was able to submit bonds on a federal contract in Colorado supported by an affidavit (Standard Form 28) stating that ABBA Bonding had assets with a net worth of over $126 million. Although no assets were placed in escrow for the benefit of the government, the U.S. General Services Administration accepted the bonds anyway. Mr. Sears eventually filed for Chapter 11 bankruptcy in the Southern District of Alabama, and it was made clear from the bankruptcy proceeding and legal depositions that most of the $126 million never existed. JBlanco Enterprises, a small business subcontractor performing work on federal contracts, nearly was forced to declare bankruptcy as a result of a deficient individual surety bond placed on a federal project that later proved to have no assets behind it.

Another notable instance surfaced in March 2010, when George Douglas Black, Sr., an individual surety doing business as Infinity Surety, was arrested and charged by the U.S. Department of Justice with mail fraud for allegedly selling more than $25 million of worthless construction bonds to 150 different construction companies on local, state, and federal public works projects, while receiving $2.9 million in fees. Among Black's alleged victims were the U.S. Department of Navy, the Beaumont Independent School District of Texas, and the Monroe Airport in Monroe, Louisiana. It is alleged that Black repeatedly pledged the same small piece of real property to insure multi-million dollar state and federal construction contracts.

These, unfortunately, are not isolated instances. Other examples exist, both past and present, showing where individual surety bond assets proved illusory, uncollectible, or deficient.

Legislative Solution

H.R. 3534, the "Security in Bonding Act of 2011," is a common-sense solution to this problem. The bill requires individual sureties to pledge solely those assets defined as "eligible obligations" by the Secretary of the Treasury and to provide those assets to the federal contracting authority, which will deposit them in a federal depository designated by the Secretary of the Treasury, ensuring that pledged assets are sufficient, convertible, and in the physical custody and control of the federal government. This is nothing more than what now is statutorily required of contractors who wish to pledge collateral as security on a federal contract in lieu of a surety bond.

If enacted, H.R. 3534 will eliminate the gamesmanship inherent in the current regulatory system governing individual surety bonds and will remove a considerable administrative burden from federal contracting officers. Small businesses working on a construction project—either as subcontractors, suppliers, or workers on the job—have no control over the prime contractor's choice of security provided to the federal government, but they suffer the most harm financially if the provided security proves illusory. The result of this bill is that small contractors, subcontractors, and suppliers on federal construction projects will know that adequate and reliable security is in place to guarantee that they will be paid.

Position Small Businesses: Include New Construction in Contract Bundling Scrutiny

The Small Business Reauthorization Act of 1997 defines contract bundling as "consolidating two or more procurement requirements for goods or services previously provided or performed under separate, smaller contracts into a solicitation of offers for a single contract that is unlikely to be suitable for award to a small business." In order to justify contract bundling, according to 15 U.S.C. §644(e), federal agencies must demonstrate "measurably substantial benefits," such as cost savings, quality improvements, reduction in acquisition cycle times, or better terms and conditions.

In *Tyler Construction Group v. U.S., 83 Fed. Ct. 94*, a federal contracting agency called into question whether anti-bundling rules apply to procurements for new construction. In deciding the case, the U.S. Court of Federal Claims stated, "whether the bundling provisions of 15 U.S.C. §631(j) should or do apply to acquisitions for new construction is a question we leave to Congress." Clearly, the U.S. Court of Federal Claims opinion sends a message that, without legislative intervention, contracting agencies need not place procurement of new construction on the same footing for scrutiny of improper contract bundling as other procurements. In "Bundling and Consolidation: Making Sense of It All," an article published in the October 2010 issue of the *Army Lawyer*, the author writes: "[i]n some cases, agencies may find it less problematic to simply state that the requirements being considered for consolidation are new and, therefore, fall outside the scope of either the SBRA Bundling or Section 801 Consolidation provisions." Thus, in the current procurement environment, contracting agencies may seek to lessen contract bundling scrutiny simply by casting a procurement bundling small contracts as one for new construction. Use of such tactics would impede or foreclose small business participation at the prime contract level and, ultimately, lessen competition on federal projects.

Legislative Solution

NASBP urges that Congress address this question of the applicability of anti-bundling rules to new construction by introducing legislation that would amend the statutory definition of contract bundling to specifically include procurements for new construction, so that small construction businesses can more fully participate as prime contactors on federal construction projects. By undertaking this action, Congress would facilitate greater participation of small construction contractors at the prime level in the federal procurement arena; increase the likelihood that contracting agencies will meet or exceed their small business participation goals; and increase competition for federal procurements, thereby providing pricing benefits to the federal government. In short, small construction firms would be given more opportunities to compete for award of contracts which will be within their reach and resources and within their financial capabilities and surety credit.

NASBP appreciates the opportunity to address the Subcommittee on Contracting and Workforce to raise awareness about important issues confronting small construction businesses wishing to perform or performing federal contracts or supplying labor and materials on such projects. NASBP hopes its testimony proves beneficial to the deliberations of the Subcommittee and welcomes any inquiries from the Subcommittee on the matters raised in this testimony or on other matters pertinent to small businesses and surety bonding.