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Committee on the Judiciary
Subcommittee on Courts, Commercial and Administrative Law

In Support of

H.R. 3534
The Security in Bonding Act of 2011
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Thank you for the opportunity to present my personal views on the necessity for the proposed legislation. These views are my own and do not necessarily represent the views of CohenSeglias or the Naval Facilities Engineering Command, my former employer.

The bill will provide much needed certainty to a very contentious area of federal construction contracts: the acceptability of bid, performance and payment bonds issued by individual sureties.

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The issue is the validity of assets pledged by individual sureties to secure their obligations under bid, performance, and payment bonds. Without valid assets the bonds are worthless. Since December of 2004 when this problem first came to my attention, I have reviewed and provided opinions on more than several dozen assets pledged by individual sureties. I have not seen a valid asset. Not one. Based on conversations with colleagues, including many contracting professionals, I would have no hesitancy in inferring that virtually no contracting officer during this same period saw a valid asset, even though they have—on more than one occasion—accepted them.

The legislation would the remove the uncertainty associated with individual sureties' pledged assets.

The proposed legislation addresses the problem of uncertainty surrounding assets pledged by individual sureties by requiring that easily verifiable assets be presented directly to the Contracting Officer.

The acceptability of individual sureties has been addressed previously.

In 1990 the Federal Acquisition Regulation (FAR) was modified to eliminate a serious problem: pervasive fraud and misrepresentation by individual sureties in government construction contracting. Rather than eliminate the use of such sureties, the FAR Council shifted the emphasis from ascertaining the estimated net worth of two or more individual sureties to requiring pledges of liquid assets by one or more sureties in order to assure their obligations under bid, performance, and payment bonds.

The solution worked for about 12 years.

There are no direct statistics as to the efficacy of that solution. In my experience and that of my colleagues, the individual surety problem simply went away—for about twelve years. It's easy to understand why. It is one thing to allege you own assets worth, say, two hundred million dollars to induce your acceptance as a surety. It is a wholly different thing to subject those assets to potential liquidation to meet your obligations as a surety. Moreover, the burden was shifted to the surety to demonstrate the asset's value. Prior to 1990, the principal individual surety asset was real estate, since it was not placed under the government's control, but its value contributed to net worth. After 1990, the government required a paramount lien on the entire property and could require its complete liquidation in order to satisfy the government's or subcontractor's and materialmen's claims. As a result, real estate virtually disappeared as an asset.

The solution worked because individual sureties largely disappeared.

When I say the problems went away, let me be clear—it was the individual sureties that went away. A GAO report from 1989 on proliferation of problems with individual sureties noted that there had been a marked increase in bid protests primarily regarding the rejection of individual sureties. In 1987 there were 6 such decisions, by 1988 there were 21 and in the first half of 1989, 23. The ultimate total for 1989 was 62. The year the rules changed, 1990, there were 30 protests involving individual sureties. In the 20 years between January 1991 and December 2011, there were a total of 21 cases using the term "individual surety" and, of those, only 13 were decided under the new rules. Again, the experience of my colleagues was that the new rules did not eliminate the protests so much as the source of the problems, individual sureties themselves.

Then personnel changed, as did the acquisition rules, and the corporate memory waned.

With a few exceptions, something equally dramatic happened during that 20-year period: almost everyone who had ever seen or dealt with an individual surety retired or was placed in a position where the size of the construction projects was too large to be bonded by even the most aggressive individual sureties. Perhaps more important, by the year 2000 most construction contracts were awarded in relative opacity as compared to the process used prior to 1995 when the competitive bidding rules changed. In the late 1980s when individual sureties were most problematical, the almost exclusive methodology for awarding contracts was public opening and inspection of sealed bids, including the bonds. By 2000, virtually all of the contracts that would be attractive to firms unable to obtain corporate sureties—were awarded by negotiation, many non-competitively under the 8(a) program. This, coupled with the fact that smaller contracts had been devolved to field activities without counsel, created the conditions for a "perfect storm". Thus, contracting personnel without any experience dealing with individual surety issues, without benefit of legal counsel, with deadlines to meet, with no competitors looking over their shoulders, and with a new crop of individual sureties have had to make decisions about individual sureties they are ill-equipped to make.

Pledged assets were as varied as they were deficient.

As we began noticing the higher influx of individual sureties around 2004, it became abundantly clear that the pledged assets were as varied as they were deficient. Because of my interest and growing—by default—expertise, I was asked by the Department of Treasury's Financial Management Service to be a person to whom they referred inquirers on individual surety questions. In that role, I had the opportunity to advise contracting officers and attorneys at the Departments of Justice, Treasury, State, Transportation, Veterans Affairs, the EPA, Federal Bureau of Prisons, GSA, NASA, the Corps of Engineers, Air Force and several state government officials. Even with this exposure, I have yet to see a valid asset supporting an individual surety bond.

After 1990, the "individual" in "individual surety" became superfluous.

Almost without exception, the problem has been the pledged assets. As I mentioned earlier, the 1990 changes to the rules shifted the emphasis to the pledge in escrow of liquid assets and paramount liens on pledged real estate. The individual of "individual surety" in effect became superfluous. Or at least that was the intent. When confronted with the discrepancies between the asset pledged and the assets that are allowable, individual sureties usually argue that the list of acceptable assets is inclusive, not exclusive. They argue that as long as the asset does not fall into the category of one of the listed, expressly excluded assets, the Contracting Officer has the discretion to find it acceptable. Accordingly, the argument goes, any asset that can be dreamed up is worth a shot. If the contracting officer in his or her discretion disagrees, well, the bidder/contractor, usually a small business, loses without any real recourse and the individual surety walks away—sometimes with the bond premium.

The Court of Appeals for the Federal Circuit underscored the uncertainty problem.

In a sense, the Court of Appeals for the Federal Circuit underscored the uncertainty problem in a case called Tip Top Construction v. U.S. In that case the Court found that the Contacting Officer reasonably determined that the pledged asset was--on a continuum between acceptable and unacceptable--"less like cash, stocks or bonds [acceptable assets] and more akin to jewelry, furs and antiques [unacceptable assets]." That analysis is not helpful in the long run. The individual sureties will simply argue that they lost a close call and that any and every subsequent situation is different. Conversely, the Contracting Officer is placed in the position the Court seeks for him or her to avoid when it said: "A contracting officer should not have to be an expert on the market for particular commodities in order to evaluate the value and liquidity of a pledged asset."

Certainty matters and it takes time, but not too much.

Contracting Officers are required to exercise discretion in these cases to allow offerors to remedy minor defects in submitted bonds, time permitting. Moreover, where the matter involves small businesses who may not be as familiar with Federal contracting as they should be, Contracting Officers are rightfully reluctant to reject a bond that at the bidding stage would eliminate the small business from consideration or at the performance stage would require termination for default. At the Naval Facilities Engineering Command (NAVFAC), the typical response to a deficient bond was to prepare a comprehensive analysis, mark those areas where changes or additional information was required, and allow the offeror/contractor to make the corrections. We would do this despite the fact that offerors/contractors are required to submit legally sufficient and correct information with the bid or proposal itself. There is also a legal requirement that such matters be treated as "responsibility" issues such that informalities are not to be treated as disqualifying unless there no time left to correct them.

Individual sureties regularly assert that they are awash in assets in hundreds of millions of dollars in assets; its time to convert them to eligible obligations.

Those who disagree that there is a problem would still have no argument that the solution—requiring the individual sureties to liquidate their assets in order to acquire the requisite amount of eligible obligations—would impose a hardship. The individual sureties would have otherwise had to put the assets at risk of liquidation under any circumstances. Change of asset form would not seem to be an undue burden.

***Tip Top*, still the best example of what happens when unacceptable assets are pledged.**

The individual surety is required to complete an affidavit. One thing the affidavit requires is describing "...the assets, the details of the escrow account" and attaching "...certified evidence thereof." That seems reasonable enough; the surety's submittal should be totally self-contained and answer all possible questions. In response, the surety attached a "Certificate of pledged assets". The certificate described the asset as "... previously mined, extracted, stockpiled and marketable coal ..." located on the surety's property also known as Permit No. R-707. The amount of coal pledged was in terms of dollars, $1,800,000. That was about 0.1% of the alleged value of the coal, again in terms of dollars. Imagine now, if you will, what $191,350,000 worth of coal looks like. Hold that picture.

The contracting officer rejected the coal, and the bid, on the basis that the surety's asset was speculative citing to the FAR provision that makes speculative assets unacceptable.

Numerous interchanges ensued. Ultimately, the surety offered to provide quality, quantity and market price information--for the first time. The contracting officer refused to budge and sent another letter reaffirming that the asset was speculative. The bidder protested to the Government Accountability Office (GAO) basically arguing that the agency had the burden to show why the asset was unacceptable. The agency responded that the certified coal lacked quality information so that any estimate of its value or how much effort it would take to liquidate was purely speculative.

The surety provided quality information pertaining to the coal that indicated that the coal was actually "coal refuse," i.e., a mixture of coal and dirt thrown away as part of a deep mining operation on nearby land. Indeed, a consulting firm had prepared a "Limited Scope Estimation of Recoverable Sewell Coal Tonnage From the Coal Refuse Facility Identified As Permit No. R-707" but specifically did not analyze any material from that site, but from a site which might or might not have been indicative (consultant's characterization) of the material at site R-707. So, assuming a recovery of 24%; and assuming the coal is of an assumed quality; assuming that reprocessing is economical; assuming the estimate of coal tonnage at the site was correct; and assuming that a processing facility was constructed; then the assumed output would be worth $79 per ton. If any of those assumptions are wrong, then it wouldn't be.

And there were other problems. The surety had no mining permit to mine (remember, it’s underground again) or process the coal refuse. The only permit applicable to R-707 was for final reclamation of the land by spreading the grass seed over the soil already covering what the surety had characterized as a mountain of coal.

So, to revisit your image of the pledged coal, who among you envisioned grassy fields with new growth timber showing no signs of mined, extracted, and stockpiled coal?

This process took from February 19, 2008 when Tip Top's bid was rejected, through February 29, 2008 when the protest was filed at GAO, through May 5, 2008 when GAO issued its expedited decision, through May 15, 2008 when the complaint was filed at the COFC, and finally to April 29, 2009 when the CAFC decided the case.

One would have thought that it would be clear to everyone that coal was a speculative asset and would not be proffered again—at least by anyone who had read the Tip Top case. Even if the regulations were no real deterrent to asset experimentation, a determination that coal and other commodities were speculative as a matter of law would seem to have ended the discussion.

In 2010, a few months before I left government, I got a query regarding certain performance and payment bonds submitted to the Architect of the Capitol. I asked for a copy and saw that the surety in the Tip Top case was being used by the awardee for performance and payment bonds. I saw the "normal" devices listed in the Affidavit that this particular surety used: trust receipts, trust indentures and--a new twist--"a copy of a bill of sale to the asset to be deposited in escrow" that would be "provided on request."

The next page contained a document headed Irrevocable Trust Receipt (ITR). The ITR referenced an agreement between IBCS Mining, a company owned by the surety, and Wells Fargo Bank, NA. The agreement provided that Wells Fargo would issue ITRs that would represent Wells Fargo had been made Trustee (holding a "first priority security interest" in whatever ownership rights the surety has in "property described in Schedule A") for the benefit of the AOC.

The property described in Schedule A was "surface, previously mined, coal" which appeared to be "coal refuse". Perhaps “asset uncertainty” isn’t the real problem with individual sureties, but just the real problem’s most gentle characterization.