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Surety Bond Quarterly

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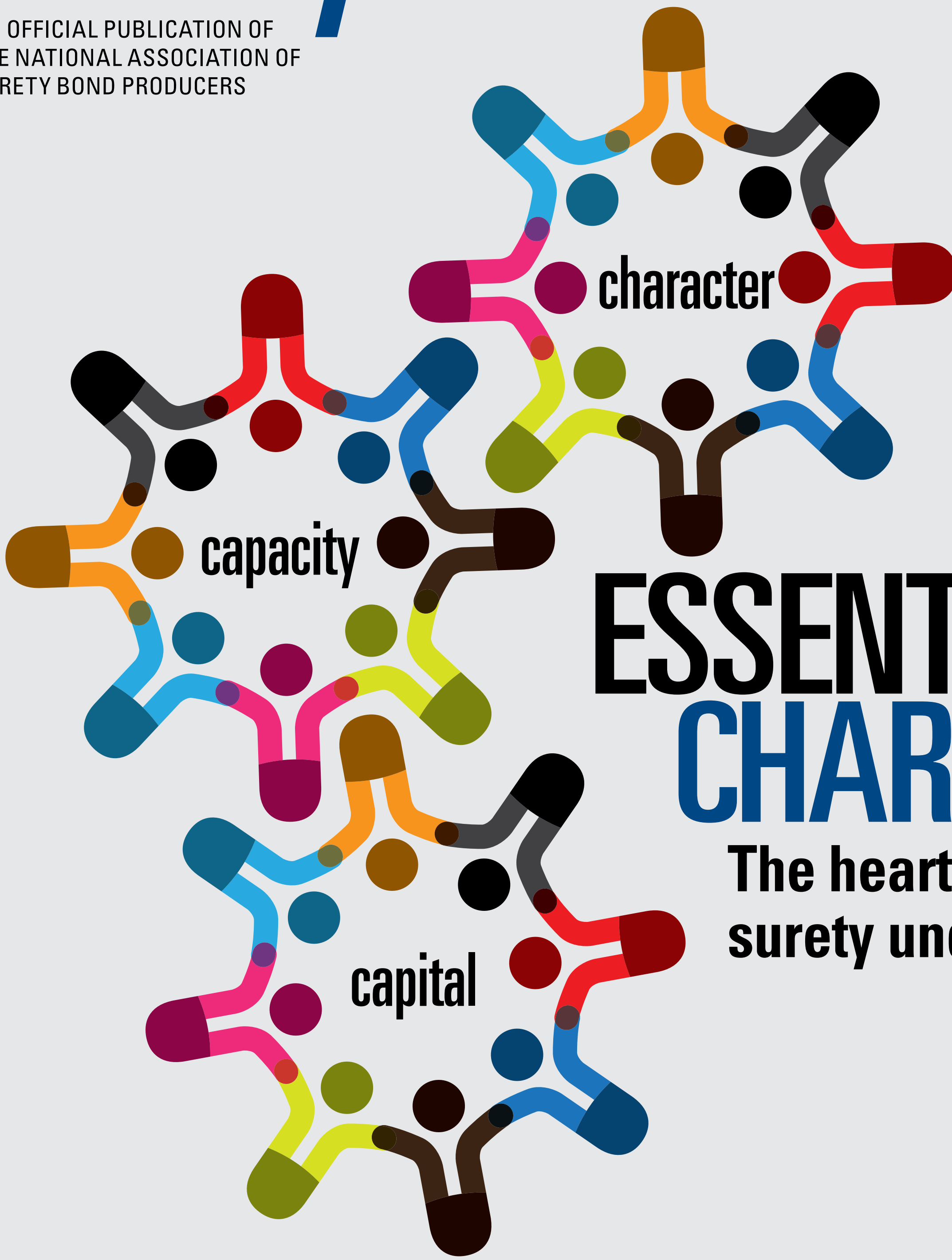

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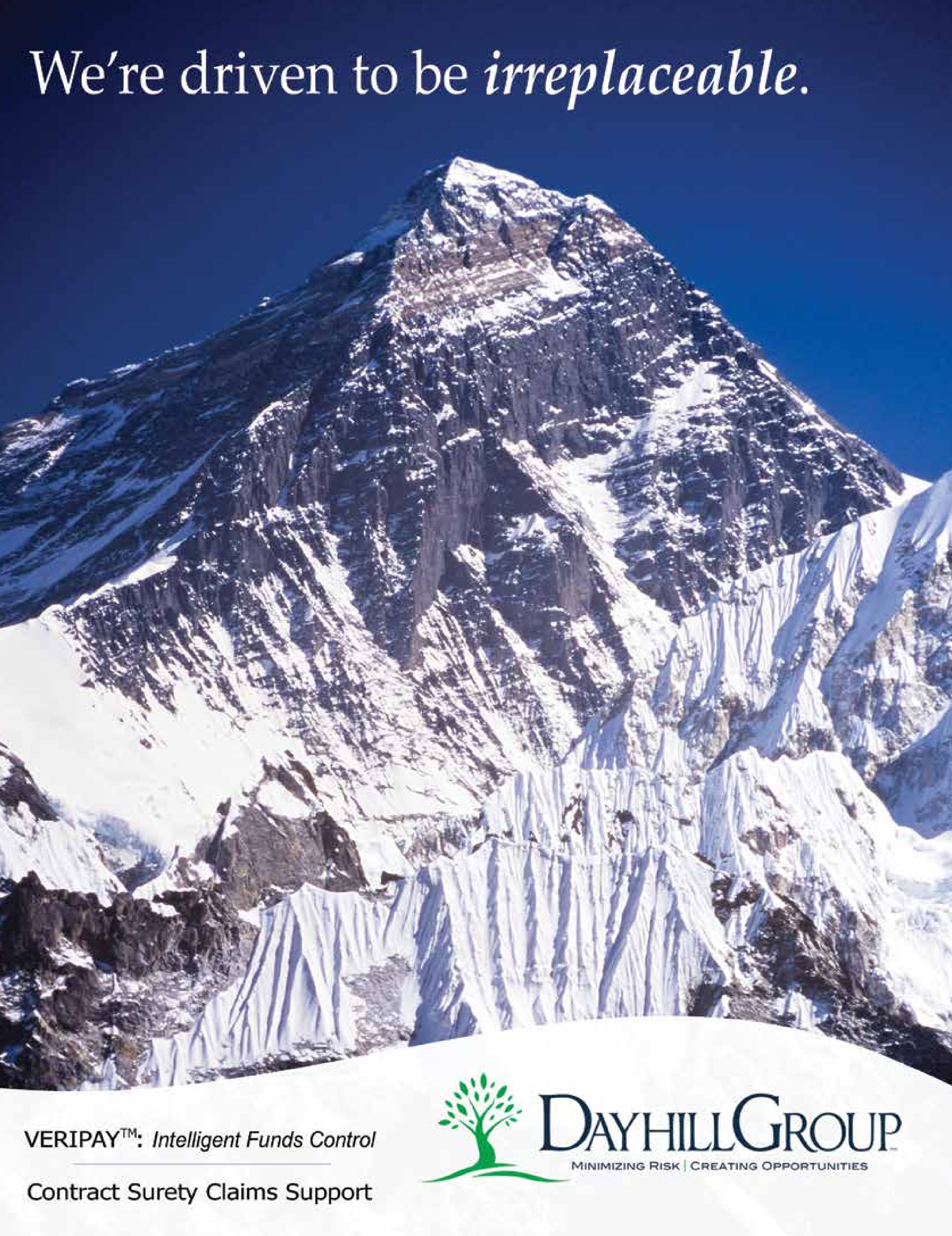
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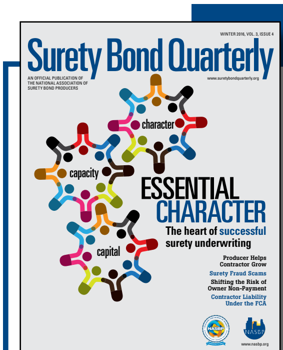

WINTER 2016

Every bond producer knows that a number of components go into building and maintaining a thriving business. Capital and capacity create the ability to fulfill an obligation, while character shows the willingness to do so; taken together, they make the measure not only of success, but also of reputation. And while capital and capacity may change over time, character is the constant. This issue examines pitfalls to avoid, resources to explore, and even a model to emulate in striving to do and be the best for clients.

View this issue, past issues and Web-exclusive content online anytime at www.suretybondquarterly.org.

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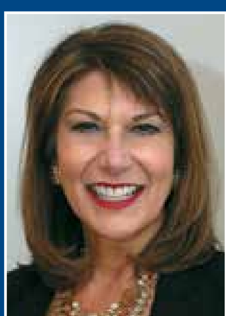

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Building Character and Acquiring Knowledge Go Hand-in-Hand

Capital, capacity, and character, the so-called three Cs, are at the heart of successful surety underwriting. Examining capital and capacity essentially looks at a firm's *ability* to fulfill an obligation; examining character reveals a firm's *willingness* or *temperament* to fulfill an obligation. We often associate good character with integrity or, stated otherwise, moral soundness. A firm of high character is one whose management has a trade reputation of maintaining honest dealings, engendering confidence in those with which the firm contracts. The firm's business record and reputation should point to a distinct history of honest, forthright dealings and the demonstration of a consistent determination to fulfill obligations. Such a record speaks to the firm's and its management's likely way of acting in the future.

In the absence of proper character, however, capital and capacity alone cannot provide confidence to the underwriter that a given firm will perform. Exhibiting high character dependably is even more remarkable given the incredibly competitive and complex construction marketplace for contracting firms. In such an environment, a record of high character is entirely earned and never mere happenstance. Management must set and promote a deliberate culture to achieve high character behavior—not an easy task. Increased compliance burdens and the heightened competitiveness of today's construction marketplace may create considerable pressures to "cut corners" on good decision-making, perhaps tempting more than a few to slacken sound behavior. People may also be tempted to loosen their ethical behavior when they perceive others to be doing the same. They adopt situational ethics—"hey, if they can get away with it, so can I"—as an excuse to justify something they otherwise know or should know to be wrong.

"DO THE BEST YOU CAN UNTIL YOU KNOW BETTER. THEN WHEN YOU KNOW BETTER, DO BETTER."
–MAYA ANGELOU

Mistakes also can be made as a result of not being informed or staying on top of industry developments. Such mistakes sometimes are attributed to slips in character, regardless of whether the mistake was unintentional or arose from ignorance. Making an on-going commitment to staying informed about industry developments and changes demonstrates professionalism and positions producers and their clients to understand what should be done or not done. The whole notion of ethics training underscores the belief that individuals can learn to "do the right thing" and to build sound character.

This Winter issue of the *Surety Bond Quarterly* touches on many of the dramatic changes and attendant pitfalls shaping today's exacting contracting environment for construction contractors and for the surety companies providing them surety support. Articles included focus on the new rules surrounding the U.S. SBA government-wide mentor-protégé program for small firms; the ongoing issue of surety fraud scams; recent developments under the federal False Claims Act; and the danger of owner nonpayment. This is information is intended to make you and your clients better professionals. The issue also contains an inspiring profile of a high-character contractor, Anvil Builders, whose CEO, Hien Tran, was the 2015 ENR Award of Excellence winner, recognized for his commitment to the construction industry and to assisting veterans to access construction careers.

Those intent on building character are those who embrace that they must never stop learning or striving to do better. I hope the information in this issue encourages you on both fronts.

Warmest regards,

Mark McCallum
NASBP CEO

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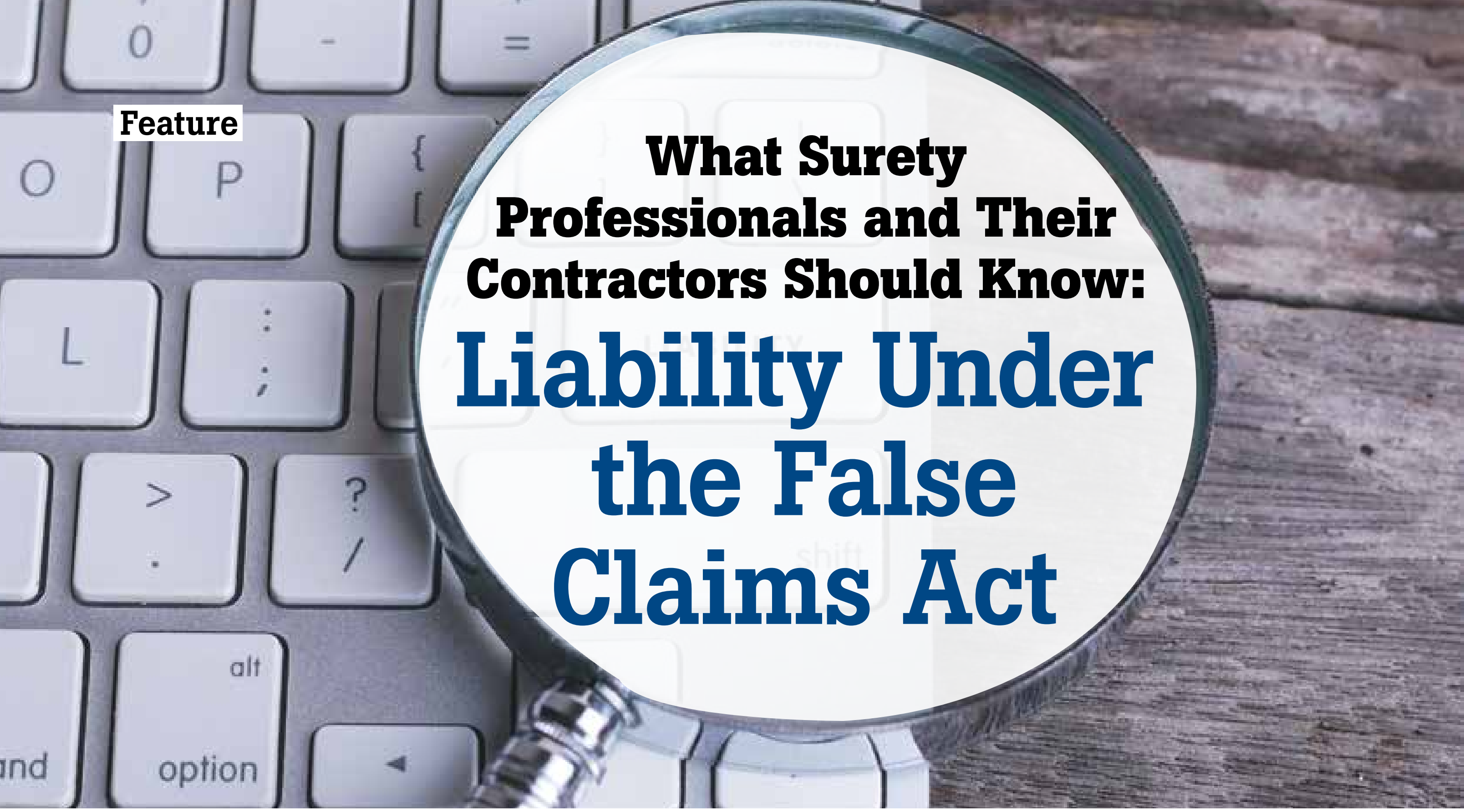
The three most important things in surety are:

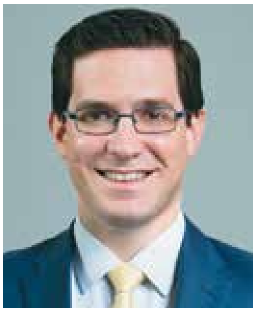
Relationships, **R**elationships

& **R**elationships

Feature



What Surety Professionals and Their Contractors Should Know: Liability Under the False Claims Act



BY W. BARRON A. AVERY & WILLIAM B. O'REILLY

OVER THE PAST year, *Surety Bond Quarterly* has featured a series of articles devoted to select areas of federal contract compliance that are often overlooked by contractors but that are of the utmost importance to surety professionals and their contractors. Through this federal government contract compliance series, readers were first introduced to wage rate requirements under the Davis Bacon Act and made aware of their need to observe certain limitations on subcontracting. Next, a feature article provided an in-depth look at the federal government's policies for combating human trafficking and the costly consequences for those contractors that have failed to comply with those requirements. The series then turned to the complicated world of small business subcontracting, with a particular emphasis on the Department of Transportation's Disadvantaged Business Enterprise program. Finally, readers were educated on the affirmative action policies enforced by the U.S. Department of Labor's Office of Federal Contract Compliance.

As these compliance requirements have grown more intricate, so too have the tools used by the federal government to enforce them. Federal agencies have a wide array of enforcement methods, such as suspension and debarment, termination for default, and monetary claims against contractors. However, one enforcement tool in particular looms over all others, both for its unpredictability and for the ruinous consequences it can inflict on contractors—the False Claims Act. This article concludes the federal government contract compliance series with a discussion of the dangerous pitfalls of the False Claims Act, the significant risks associated with violating the Act, and conclusions for contractors seeking to avoid liability.

A. The False Claims Act: Defrauding the government is different—and easier—than you think

Contractors are universally aware that defrauding the government, just as defrauding any other customer, is strictly prohibited and that contractors can incur significant liability. However, many contractors would be surprised to learn that this prohibition reaches beyond typical types of contract fraud, such as submitting false invoices for work that was never performed or that overstate costs or labor rates to inflate the final bill. Under an evolving doctrine known as "false certification doctrine," a contractor that falsely certifies that it has complied with any of the myriad compliance policies imposed by the government, such as subcontracting goals or human trafficking policies, may be liable under the False Claims Act.

The False Claims Act is distinct from traditional fraud in important other ways as well. Unlike private customers alleging fraud, the government is not required to prove that it has suffered any damages in order to bring a false claims suit—all that is required is that the contractor have submitted a claim it "knew" was false. And this knowledge requirement is less of a defense than it seems at first blush, as a contractor that is merely reckless in disregarding whether the claim was true or false is deemed to "know" of its falsity under the Act. Taking all of this together, violating the False Claims Act is strikingly simple; and contractors with weak or non-existent compliance systems are at risk of inadvertently committing multiple violations.

B. False claims violations are costly and unpredictable

When a contractor violates the False Claims Act, it may be subject to two different types of liability—actual damages that are any out-of-pocket loss suffered by the government and statutory penalties that are also sometimes referred to as fines or statutory damages. These penalties are prescribed by law between $10,781 and $21,563 and are assessed for each "claim" submitted to the government. Individual invoices are often treated as separate "claims" when calculating these fines, leading to large penalties even when the government suffers no actual harm.

In addition to being costly, allegations of violations of the False Claims Act can also surprise contractors that are unaware of their risks. Contractors without a direct relationship to the federal government, such as subcontractors or contractors performing federally funded state contracts, are subject to liability as much as federal prime contractors. And under the Act's whistleblower provisions, individuals may bring suit on behalf of the government based on their own knowledge, catching contractors flat-footed in the absence of any government investigations. Two recent examples illustrate these risks.

In August 2011, Minnesota Transit Constructors, Inc. and a group of subcontractors agreed to pay $4.6 million to settle a False Claims Act suit related to the construction of a federally funded light rail system. None of the defendants held a federal contract. Despite this, the federal funds used to help fund the contract implicated the False Claims Act. When the government alleged that the contractors had falsely certified their compliance with requirements to use Disadvantaged Business Enterprises, they had little choice but to settle.

More recently, in January 2015, a Wisconsin architecture and construction firm, Novum Structures, LLC, agreed to pay $3 million to settle allegations of fraud and false claims relating to construction contracts it had performed. Specifically, the government alleged that the contractor incorporated foreign construction materials into its projects in violation of domestic preference requirements included in its contracts. The government did not allege any defects in the work performed by the contractor—the mere fact that it had falsely certified compliance was enough.

The risk of inadvertent violation has only increased since. Last summer, in a case titled *United Health Services v. United States ex rel. Escobar*, the United States Supreme Court ruled that, in certain circumstances, a contractor need not expressly certify compliance with contractual provisions in order to have submitted a false claim. Instead, a contractor may be deemed to have submitted an "implied" false certification when it misleads the government through half-truths or omissions. This further presents unique risk to contractors in the construction industry, where tight deadlines, unexpected roadblocks, and available supplies often necessitate changes that are not always communicated to the government in a timely manner.

C. Conclusions for sureties and their contractors

Even as avoiding the False Claims Act becomes more and more difficult, the consequences for violating it have become increasingly severe. Nevertheless, contractors can take certain steps to minimize their risks, such as:

- Implementation of a comprehensive compliance program, including monitoring and training of employees, for compliance with all significant contractual requirements;
- Independent final review of all invoices by a project manager or employee with similarly extensive knowledge of the project to flag non-compliance issues; and
- Regular communication to the government, as advised by counsel, of difficulties in contract performance as well as contract compliance.

In addition to implementing these policies and procedures, contractors should regularly consult with outside counsel regarding changes to the regulatory environment and to obtain timely review of any possible violations. By pro-actively promoting the rigorous compliance policies outlined over the course of this series, surety professionals and their contractors can limit their exposure to liability under the False Claims Act. ●

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A Business with a Mission:

Construction Firm that Aids Veterans Grows with Bond Producer's Guidance

In 2015, Anvil Builders executives, from left, Co-founder and Director Richard Leider, President and CEO HT Tran, and COO Alan Guy, celebrated Tran's receiving the ENR Award of Excellence, a prestigious recognition for leadership and innovation in the construction industry.

HIEN MANH "HT" Tran understands firsthand the problems faced by service members leaving the military; his own life-threatening injuries, suffered while he was serving in Iraq, changed his life. Six years ago, when he started San Francisco-based Anvil Builders with two partners, one of his primary missions was to provide good jobs for veterans and to help them make a successful transition to civilian life.

Tran's determination to build a solid business and to make a difference for other veterans has gained him the respect and support of many people in the construction industry. One of them is Mark Munekawa, Senior Vice President of Surety at Woodruff-Sawyer & Co. in San Francisco. Munekawa helped Tran's fledgling company receive the surety program it needed to secure work and has provided advice and guidance that has helped Anvil Builders grow.

"HT has done things the right way," said Munekawa. "He is building an organization that we hope will continue to grow and prosper as a sustainable business."

Tran, the son of Vietnamese immigrants, has always had a desire to serve, so he chose to enlist in the Army infantry after earning a college degree in marketing. "As infantry guys, we were known as the jack of all trades," he said. "People always ask me why I chose construction; it really comes from my survival of my deployment in Iraq."

In May 2008, Tran and his captain suffered life-threatening injuries when an improvised explosive device exploded. Both survived, but Tran lost his right eye and had a titanium rod permanently implanted in his left femur. He spent 15 months recovering at Walter Reed Army Medical Center.

"Dealing with the injury was the easy part," he said. More difficult was contemplating a return to civilian life; he had told his family a short time before that he would be making the Army his career. "Now what was I supposed to do? I had no idea where I was going," he said.

NASBP Bond Producer Mark Munekawa (left) of Woodruff-Sawyer & Co. with HT Tran (right) of Anvil Builders onsite at the San Francisco Transbay Transit Terminal, for which Anvil Builders is a subcontractor.

During the long months of recuperation, Tran met Bob Nilsson, a retired Marine and former vice president of Turner Construction. Nilsson mentored Tran and told him that he would one day open his own business—a prediction that Tran discounted.

Tran took a procurement job at a major defense contractor at that time but chafed at life in a cubicle. "This was not how I saw my life; this was the life I was avoiding before I joined the Army," he said. At the same time, his former platoon members were calling him for advice on job hunting. "They had a hard time writing a resume and interviewing; they

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couldn't hold a job, and it was putting a lot of pressure on their families."

Construction offers opportunities

Tran decided to open a business that could help with his problems and those of other vets. He chose construction because of the opportunities opening up with Baby Boomers retiring and because he felt the hands-on, task-oriented business would be a good fit for veterans.

Nilsson introduced Tran to Richard Leider, an experienced and successful local businessman. Tran became President and CEO of Anvil Builders (his former platoon's name), and Leider became "special ops" in business development. Alan Guy, a construction project manager, became COO.

When Anvil Builders incorporated in 2010, the economy was still in bad shape. Veteran-owned firms were also suspect, because several were serving as pass-through fronts for other contractors. But Tran and his partners enjoyed the challenge. "We figured that 2010 was the bottom of the barrel, and if we could start our business at the bottom, ride it out and come out on top, when the next bottom comes, we will already know what it's like to survive."

Tran wanted to build a company that self-performed its work and that would be considered a teaming or joint venture partner rather than a subcontractor. "You're digging, your hands are dirty, and you really have to put some hard sweat into what you're doing. But I can resolve issues, track the progress of what I'm doing every day and build our own team to do the work," Tran said. "When I walk onto a site or a project that we finished, I can honestly say, 'We built that ourselves.' There's a satisfaction of saying that my team did this."

"We want to be able to do the job right the first time and to team up with the people that we're working with so that we're all on the same page, so that we can build trust and our reputation and credibility that way," he added.

Munekawa (left) and Tran (right) examining the site of the San Francisco Transbay Transit Terminal project.

Building a solid foundation

Tran met Mark Munekawa at Woodruff-Sawyer & Co. through another mentor. "We were going out for our first job, and we needed a bond for a $500,000 project. We talked to Mark, and although he really didn't know us, he took a leap of faith," Tran said. "Mark asked us about our business plan and our growth, and said 'We will give you that bond, but these are the expectations that we have.' We were so ecstatic. That's how our relationship grew."

"We started working with HT even before he got his contractor's license," said Munekawa. "We worked with him on how to set up and capitalize his company and how to get his first bond. We educated him about some of the issues from a surety perspective that are important for a contractor to know.

"It's not just that we've provided him bonds; it's that we've been

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"THEY WERE WILLING TO TAKE THAT RISK AND HELP US MANAGE THAT RISK TO MAKE SURE THAT WE ARE WHERE WE ARE RIGHT NOW. THEY WILL ALWAYS BE CONSIDERED PART OF OUR SUCCESS."

–HT TRAN

able to provide him with advice and counsel. We tried to help him along the way and do the right things to help him grow his business. Part of what we've tried to do is educate him on what sureties want and why it's good for him to take these things into consideration.

"We like emerging contractors that build sustainable business organizations, and HT has done that."

Munekawa also helped Tran build other relationships, introducing him to the bankers and the CPA that Anvil Builders now uses.

"They are partners of our team," Tran said. "They were willing to take that risk and help us manage that risk to make sure that we are where we are right now. They will always be considered part of our success."

Growing and improving

In its early days, Anvil Builders took on small jobs averaging $100,000 to $500,000; but that average has grown to $2.5 to $5 million today. Current projects include the Transbay Transit Terminal, the Moscone Center Expansion project, and the Candlestick Point project.

Tran has made some progress in finding work for veterans as well. Approximately 10 percent of Anvil Builders' employees are veterans; he'd like to see that grow to 50 percent over time. He has worked with local construction unions to get veterans into apprenticeship programs, and he serves on the veteran hiring committee of the United Contractors. Earlier this year, Tran became a member of California's Veteran Advisory Council.

Tran has earned national recognition for his advocacy for veterans and for his approach to building his company; *Engineering News-Record* presented him with an Award of Excellence in 2015. But Tran is uncomfortable being singled out for these honors and says they should go to everyone who has worked to make Anvil Builders a success.

"I think it's a great reflection on how my team has come to be a company and how they believed in the concept and philosophy of what we want to execute. Without them, I wouldn't be able to do all the things that I wanted to do," he said. "What I love about my company is that the team has adopted the same mentality that I have; there's still a lot of work to do and still a lot of things we can improve on." ●

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Feature

IS THE SBA ALL SMALL Mentor-Protégé Program Right for Your Contractor Client?

SBA Program offers small contractors an opportunity to work with large contractors and to pursue federal projects that may be too large to pursue on their own.

BY LORI ANN LANGE

BY NOW, MANY in the construction contracts community are aware that the U.S. Small Business Administration (SBA) has established a new mentor-protégé program open to all small businesses, known as the All Small Mentor-Protégé Program. This article will discuss the purpose of the program, the minimum qualifications of protégés and mentors, and how interested construction companies can apply to the program.

A. Purpose of the All Small Mentor-Protégé Program

The purpose of the mentor-protégé relationship is to enhance the capabilities of the protégé and to improve its ability to successfully compete for government contracts by requiring the mentor to provide business development assistance to the protégé. The types of assistance that a protégé can receive from its mentor include:

- Technical and management assistance. Under the program, the mentor's expertise, resources, and capabilities can be made available to the protégé.
- Financial assistance. Mentors can own equity interests of up to 40% in the protégé firm to help the protégé raise capital. Mentors also may provide loans to the protégé.
- Subcontracts. Either the mentor can award subcontracts to the protégé or the protégé can award subcontracts to the mentor.
- Trade education.
- Assistance in performing government contracts through joint ventures. The mentor and protégé can enter into joint venture arrangements to compete for government contracts.

Mentors are encouraged to provide assistance relating to the performance of contracts set-aside or reserved for small business so that the protégé may more fully develop its capabilities.

B. Eligibility Requirements

1. The Protégé

In order to be eligible as a protégé, the firm must qualify as small for the size standard corresponding to its primary North American Industry Classification System (NAICS) code. In determining which is the firm's primary NAICS code, SBA will look at such things as the distribution of the firm's receipts, employees, and costs of doing business for the firm's most recently completed fiscal year. Firms can self-certify that they qualify as small, although SBA may check procurement databases to verify size status for Service-Disabled Veteran-Owned small businesses and Women-Owned small businesses.

If the firm does qualify as a small business for its primary NAICS code, the firm still may apply to the All Small Mentor-Protégé Program if it is seeking business development assistance with respect to a secondary NAICS code and the firm qualifies as small for the size standard corresponding to that secondary NAICS code. In that case, the firm must be able to demonstrate to SBA how the mentor-protégé relationship is a logical business progression for the firm and will further develop or expand the firm's current capabilities. Keep in mind that SBA will not approve a mentor-protégé relationship if the firm has no prior experience in the secondary NAICS code.

Generally speaking, a protégé can have only one mentor at a time. SBA may permit a protégé to have a second mentor if the second mentor-protégé relationship will not compete or otherwise conflict with the first mentor-protégé relationship. In general, the second relationship will not compete with the first relationship when the second relationship pertains to an unrelated NAICS code or the protégé is seeking to acquire a specific expertise that the first mentor does not have.

2. The Mentor

In order to be eligible as a mentor, a firm must demonstrate that it is committed to helping the protégé. In addition, the firm must meet the following qualifications:

- Be a for-profit firm.
- Have a favorable financial position and be able to carry out its responsibilities to assist the protégé.
- Possess good character.
- Not be suspended or debarred.
- Be able to impart value to the protégé as a result of lessons learned and practical experience gained or through its knowledge of general business operations and government contracting.

There are no size restrictions for a mentor. A mentor can be a large business or a small business.

Generally speaking, a mentor can only have one protégé at a time. SBA may authorize a mentor to have more than one protégé if the mentor can demonstrate that the additional mentor-protégé relationship will not adversely affect the development of either protégé (for example, the second firm may not be a competitor of the first firm). Under no circumstances will a mentor be permitted to have more than three protégés at one time.

C. Applying to the All Small Mentor-Protégé Program

SBA started accepting applications to the All Small Mentor-Protégé Program on October 1, 2016 through email. Starting November 1, 2016, mentors and protégés apply through SBA's website—www.certify.sba.gov—and will need to complete an online training module.

As part of the application process, the mentor and protégé must enter into a written Mentor-Protégé Agreement (MPA) setting forth an assessment of the protégé's needs, describing the assistance the mentor commits

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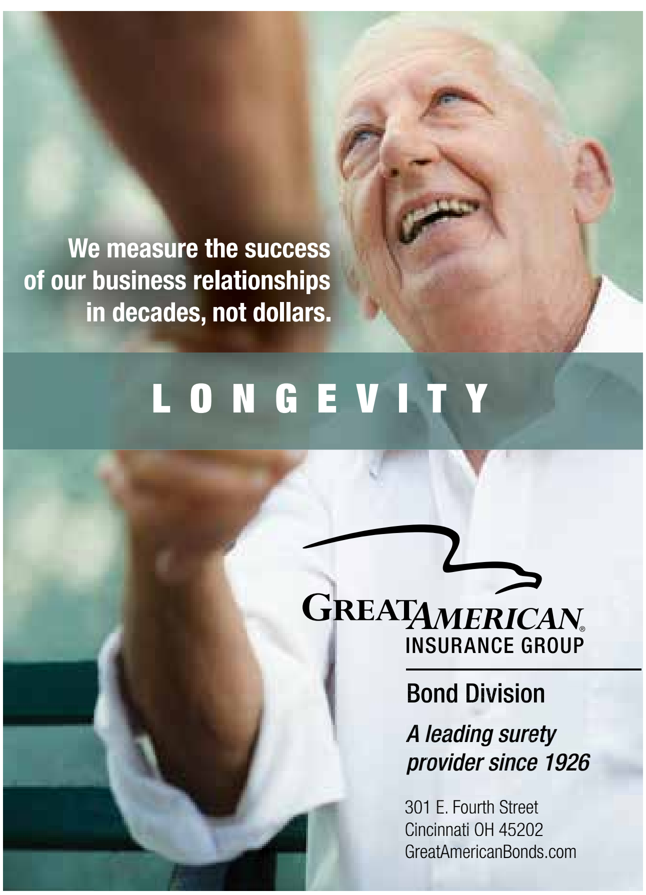
In this issue, "*Shifting the Risk of Owner Non-Payment and its Effect on the Surety*" by G. Scott Walters.



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to provide, and establishing a timeline for delivery of the assistance. A sample MPA is available at www.sba.gov/contracting/government-contracting-programs/all-small-mentor-protege-program/how-apply. The MPA must state that the mentor will provide assistance for at least one year but no more than three years. The agreement, however, may be extended for another three years.

The MPA must be approved by the SBA Associate Administrator for Business Development or his/her designee. SBA will not approve the MPA if it determines that the assistance to be provided is not sufficient to promote any real developmental gains to the protégé or the MPA is merely a vehicle to enable the mentor to receive set-aside contracts through its protégé.

The MPA must provide that either the protégé or the mentor may terminate the MPA with 30 days' advance notice to the other party and SBA. In addition, SBA will review the mentor-protégé relationship annually to determine whether to approve its continuation for another year. SBA may decide not to approve continuation of the agreement if it finds that the protégé is not benefitting from the relationship or the parties are not complying with the MPA.

D. Conclusion

A mentor-protégé relationship can be beneficial to both the mentor and the protégé. SBA's All Small Mentor-Protégé Program offers a unique opportunity for small construction businesses to receive assistance from large construction businesses and to work together to pursue federal construction contracts that may be too large for the small business to pursue on its own. In order for the relationship to work and not be challenged by SBA, the mentor must be committed to providing meaningful assistance to its protégé—not just use the protégé as a means to bid on procurements set aside for small businesses. Further, the protégé must be realistic in determining what type of assistance it needs, and the mentor must be realistic in determining what assistance it is willing to provide.

Lori Ann Lange, a partner in the Washington, DC office of the law firm of Peckar & Abramson, P.C., specializes in government contract law, bid protests, and corporate compliance counseling. Lange represents a range of government contractors, including construction contractors, major defense contractors, informational technology contractors and service contractors. She can be reached at llange@pecklaw.com or 202.293.8815 ext. 7103.

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Shifting THE RISK OF OWNER NON-PAYMENT AND ITS EFFECT ON THE SURETY

BY G. SCOTT WALTERS

IT IS A truism that construction is a risky business. Construction contracting is an exercise in dealing with these inherent risks. One common way involves allocating these risks among the various project delivery team members. Many contract clauses will allocate risk by shifting it from one party to another on the pretense that the party being assigned the risk is better able to absorb or control it; more likely, it is that the party shifting the risk does not want to have to deal with it. Examples of typical risk-shifting clauses found in construction contracts include: no-damages-for-delay clauses; indemnification clauses; special dispute resolution procedures; performance guarantees; and pay-if-paid clauses. For projects requiring performance and payment bonds, sureties likely will be held to these clauses in carrying out their obligations. Likewise, sureties may be able to rely on such clauses to the same extent their principals can when faced with bond claims.

One example of a risk-shifting clause with potential risks and benefits to the surety is the pay-if-paid clause. This provision, commonly found in contracts between the general contractor and its trade subcontractors, shifts the risk of owner non-payment from the general to the subcontractor. Simply put, the general contractor's payment obligation to its subcontractor only arises *if* the owner pays the general contractor for the corresponding work. Such a clause can be an extremely powerful tool for the general contractor and an extremely risky proposition for the subcontractor.

At its extreme, if the owner never pays the general contractor, then the general contractor might avoid altogether its payment obligation to the subcontractor. As a result, most states have scrutinized these clauses very carefully and found them to be enforceable only in instances where the applicable language clearly and unequivocally states that payment by the owner to the general contractor is an express condition precedent to the general contractor's obligation to pay the subcontractor and that the parties mutually intend for this condition to be in place. Further, many states have refused to enforce such provisions if the general contractor has taken some action to prevent the condition (owner payment) from occurring.

With the existence of such a risk-shifting clause, the payment bond surety for the general contractor might want to assert this as a defense to a claim of non-payment by a subcontractor. Here, the underlying premise would be that, while the payment bond obligates the surety to answer for the debt, default, or miscarriage of its principal, such obligation does not arise until payment becomes due. Whether the surety can rely upon this defense will depend on several factors. Three important factors are discussed below.

First, is the bond at issue one for a private construction project or for a public construction project? For construction projects in which a local or state government agency or the federal government is the procuring entity, bond requirements are established by statute. At the federal level, this statutory scheme is known as the Miller Act. Most states have comparable statutory bonding requirements, commonly referred to as "Little Miller Acts." Payment bonds issued for publicly owned construction projects would be subject to these statutes. As a general rule, sureties cannot rely upon any pay-if-paid provision in a subcontract covering public works construction projects as a defense to their obligations to the unpaid subcontractor. Two recent cases illustrate this.

In the 2011 case of *Glencoe Education Found., Inc. v. Clerk of Court & Recorder of Mortgages for Parish of St. Mary*, the Court of Appeal of Louisiana was asked to determine "whether a surety, which has issued a statutory bond governed by [Louisiana's] Public Works Act, may rely on a 'pay if paid' clause in a principal's subcontract as a defense to payment of sums owed to subcontractors which have performed work on a public construction project." The *Glencoe* court found that the surety could not rely upon a pay-if-paid provision in the principal's subcontract, as such reliance would render meaningless the statutory "protections afforded laborers and suppliers on public works projects[.]"

In the 2014 case of *U.S. ex rel. XLE Metals, Inc. v. Patterson*, No. 12-2634, a federal district court determined that the surety could not rely upon a pay-if-paid clause in the principal's subcontract as a valid defense to a subcontractor's Miller Act claim. In so ruling, the court looked at numerous cases from other federal district and appellate courts to find that this principle is a "well established or well settled point of law[.]" There, the court reasoned that allowing such a defense would delay Miller Act payment bond claims beyond the Act's one-year statute of limitations, amounting to a waiver by the subcontractor of its Miller Act rights. The *XLE Metals* court concluded that implied "waivers are void under the express terms of the Miller Act[.]"

Second, is the pay-if-paid clause enforceable under the law governing and interpreting the contract? For bonded private construction projects, the law of the state governing the underlying contract (that is, the common law) will likely determine whether a payment bond surety can rely upon a pay-if-paid clause in the principal's contract as a defense to a subcontractor's payment bond claim. Many states recognize that, where a pay-if-paid clause is enforceable, the surety may assert this as a defense to a subcontractor's payment bond claim if the principal has not been

In Memory

John P. Martinsen

November 8, 1934 – August 30, 2016

John was a tireless and outspoken advocate for others in the Construction and Surety Industry for over 48 years. He served our industry with honesty and the dedicated pursuit of excellence while being an enthusiastic mentor to help so many grow and prosper in work and in life. John was devoted to a beautiful six letter word – PEOPLE – and in his recent passing, grants us an opportunity to pause and remember him for how he touched our lives and contributed to our individual and collective successes. We will deeply miss his positive outlook and say goodbye to one of our visionaries, a leading light of our industry and a true friend.

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paid for corresponding work, thus excusing the principal from its payment obligation to the subcontractor. In many instances this is true even if the payment bond does not expressly incorporate the subcontract into the bond.

Other states (for example, North Carolina and Ohio) have determined that pay-if-paid clauses are void as against public policy. Here, the underlying theory is that a contractual requirement shifting the risk of owner non-payment is too great a risk for a subcontracting party that has no control over, or contractual rights against, the party withholding payment. For bonded projects in such jurisdictions, there would, therefore, be no conditional payment defense available to the principal or the surety.

Third, and related to the enforceability issue, even if the pay-if-paid clause is enforceable, can the payment bond surety rely on this defense to the same extent as its principal? Some states accept, or enforce, a pay-if-paid clause but may not permit the surety to rely upon this defense unless the bond clearly and unequivocally states that it is a conditional payment bond. Here, a court, under applicable state law, would be required to read the principal's subcontract and the payment bond separately. When issuing a payment bond in such a jurisdiction (for example, Florida), and where the principal wants to shift the risk of owner non-payment to its subcontractors, the surety would be well served to include conditional language in its bond.

Risk-shifting clauses in construction contracts may serve in some instances, such as a pay-if-paid clause, to benefit the surety, under the theory that the surety assumes no greater risk than the principal. As discussed here, whether the surety will enjoy that benefit will depend on many factors. Understanding the surety laws applicable to the type of project being bonded and the jurisdiction where the bonded work will be performed is critical. ●

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Feature

SURETY FRAUD SCAMS

BY JAY LABE

SCAM ARTISTS HAVE long presented a challenge for the surety industry. They are lured by large premiums they can clear without the bothersome overhead of underwriting departments, claim professionals, reserves, or pesky government regulators. They skillfully prey on the construction industry with convoluted, artfully crafted documents, ingenious ruses, and promises of easy surety credit for marginal or otherwise unbondable contractors. They have come to rely on the neglect of project owners to perform any meaningful due diligence or to question myriad red flags flying throughout the documents they review.

While surety fraud is not common, it is extremely damaging to its unwitting victims. They are left helpless in its wake as they confront chaotic situations and suffer major losses with no real means of recourse.

Surety fraud also results in collateral damage to our industry. It is a threat that must be taken very seriously. It tarnishes the stellar reputation that our industry has earned over decades of providing great service and value to the construction industry.

For years the surety industry has proactively confronted threats from con artists. These efforts include extensive educational programs and perceptive lobbying activities. The goal is to make the construction industry and public less vulnerable to avoidable scams.

Although I am a Colorado-based attorney, I have seen more than my share of scammers all across the country. This article provides a glimpse of my experience with surety scams over a four-decade career in fidelity, surety, and construction claims.

The early days

In the late ’70s and ’80s the most common form of surety fraud I witnessed involved surety bonds that were inelegantly forged by bond principals who were refused surety credit from traditional sources. Occasionally they took it upon themselves to get the necessary bid, payment, and performance bonds by fabricating the necessary paper, using samples of legitimate powers of attorney. Unlike the perpetrators of today’s more sophisticated scams, they were contractors. They wanted bonds, not premium.

These schemes unraveled almost immediately after the unsuspecting legitimate surety whose name appeared on the bond got notice of a bond claim but found no record that the bond ever existed. Public owners suddenly found themselves holding only worthless paper as protection against a failing contractor. Project suppliers were left with large receivables and no recourse to a payment bond or lien rights.

These clumsy deceptions resulted in serious but relatively localized damage. In some instances, litigation arose between a claimant and the surety company whose bond was forged. I have yet to see an instance where such a claim was successful. On occasion perpetrators were criminally prosecuted. Unfortunately, victims were generally left with large losses, worthless civil claims, and uncollectable criminal restitution awards.

When the surety industry became aware of these early instances of abuse, it took prompt action. The Surety and Fidelity Association of America, for example, created a “Bond Authentication Program.” Today this program continues to provide an easy means for bond intake employees of public and private project owners to quickly

ABBA World Headquarters, Lillian, AL

authenticate surety bonds. It is an excellent resource when a contractor tenders a bond from an unrecognized source or shows any sign of deception.

In addition, powers of attorney used by standard sureties have become exponentially difficult to duplicate or forge as more sophisticated fraud protection technology appears on the market. Some sureties have enhanced numbering and tracking systems to better account for all powers of attorney they issue to authorized bond producers.

Individual surety scams

Contractors are required to provide "Miller Act" performance and payment bonds on most federal construction projects. With one very unfortunate exception, federal sureties must qualify as an "Acceptable Surety" on the "Treasury List," which is also known as "Circular 570." This is the U.S. Treasury Department's highly efficient means of proactively vetting the financial health and good standing of sureties in the federal market. The Treasury List is an invaluable and readily available source of current information, including the standing of each surety with its domiciliary state regulator. For decades the Treasury List has provided an effective "one-click" means of verification for federal contracting officers who bear the ultimate responsibility for assuring that Miller Act bonds come only from reputable and currently qualified sureties.

The "Individual Surety" exception to the requirement that a surety appear on the Treasury List is problematic, to say the least. It allows federal contracting officers to accept Miller Act payment and performance bonds from individuals who supply a Standard Form 28 "Affidavit of Individual Surety" but who do not appear on the Treasury List. Instead, the individual surety is only required to pledge specific collateral as security for Miller Act bond losses and make a variety of representations that cannot be easily verified. This ill-conceived exception to surety qualification requirements has given rise to serious problems with dire consequences.

The fundamental problem with the individual surety exception is that it eliminates the contracting officer's ability to use the "one-click" surety verification process afforded by the U.S. Treasury Department's Fiscal Management Service. Without this resource, a massive and unreasonable burden is placed on federal contracting officers, who have no special training in financial underwriting and no available time or resources to perform meaningful due diligence in the midst of the demands imposed by an already complex construction procurement process. Contracting officers, who are the designated surety bond intake gatekeepers, are instantly overburdened each time they are confronted by the sparsity of information the individual surety is compelled to supply in a Standard Form 28 Individual Surety Affidavit. A meaningful assessment of the integrity and financial resources of individual surety or the sufficiency and authenticity of the assets being "pledged" quickly becomes an afterthought in these difficult circumstances.

Individual surety scam artists were quick to take full advantage of this golden opportunity. They learned to count on government indifference and lack of due diligence. They clearly understood that they would be allowed to demonstrate their financial credentials with documents made from whole cloth; to describe imaginary wealth; and to use the same cookie-cutter deceptions on multiple bonds for the very same federal agency, with impunity.

The late Morris C. Sears is a prime example of systematic abuse by an individual surety, although he was nowhere near the most prolific of his kind. Sears was very good at what he did. In 2008 he formed an individual surety business known as "ABBA Bonding, Inc." I first met him on the roof that was being replaced in the course of a remodel of the U.S. Bankruptcy Court in Denver. He grudgingly appeared in connection with a Miller Act suit on a payment bond claim he flatly denied from an unpaid commercial roofing subcontractor. Ironically, unknown to Sears, the general contractor for whom Sears had issued the Miller

Act bond was once a petitioner in the very same bankruptcy courthouse where Sears was now standing on the roof. The claimant and federal agency involved were also unaware at the time that Sears was running a nationwide individual surety business out of a small office in a mobile home in Lillian, Alabama. The full scope of Sears' activities did not come to light until more of his bonds appeared on other Denver federal courthouses and he made what turned out to be an egregious error. In what Sears believed to be a stalling tactic, he sought Chapter 11 protection from the U.S. Bankruptcy Court in the Southern District of Alabama. He then found himself in the legendary "roach motel" of a Chapter 11 from which he never reappeared. He did not seem to fully anticipate the need for or understand the impact of candor in a bankruptcy setting.

The unintended side effect of his self-serving Chapter 11 petition was to bring his many victims together before a single federal bankruptcy judge whose eyes were quickly opened as she grasped the full measure of his activities in multiple jurisdictions and the state cease-and-desist orders he had ignored. Sears was ultimately confronted with criminal charges for tax evasion and bankruptcy fraud. Those charges were awaiting trial at the time of his death in 2013.

The bankruptcy proceeding revealed that Morris Sears received large premiums on the issuance of many high-value federal and state payment and performance bonds with relatively simple and entirely fictitious representations. His Standard Form 28 Affidavits in Denver pointed to a financial statement showing "ABBA Net worth of $128,195,665.61." Large and seemingly sophisticated federal procurement entities took his word. Red flags were either unseen or uniformly ignored. His repeated representations of the massive net worth of "ABBA Bonding, Inc." was somehow seen as meaningful in the face of specific instructions on the Standard Form 28 individual surety affidavit itself that prohibited business entities from acting as individual sureties.

By the conclusion of Sears' bankruptcy proceeding in Alabama, no doubt existed that his deceptions were frequent, widespread, and highly damaging. The Eleventh Circuit Court of Appeals found that, despite a federal contracting officer's approval of the bonds, Sears never had clear title to the properties in Texas, Louisiana, and Alabama that he pledged as collateral. It also determined that his representations that the real estate was unencumbered and pledged only for specific projects and bonds was deceptive. Sears' cookie-cutter SF 28 Affidavits consistently identified the same real estate. He pledged that same property time and time again on virtually all federal projects. In each case he gave the contracting officer sworn assurance that the real estate he pledged was unencumbered. Sears also had to concede that he never had a net worth of "$128,195,665.61."

It is important to appreciate that unpaid suppliers suffered devastating losses on federal projects where Sears' worthless paper had been unwittingly accepted. At the end of the day, the suppliers simply had no meaningful recourse. The procuring entities, who accepted Sears' bonds, were unsympathetic and, for all practical purposes, uncooperative. The only creditor in the Sears bankruptcy who received payment was the Internal Revenue Service.

For many years NASBP has taken a leadership role in the fight against scams. NASBP's educational programs and lobbying efforts have had a major impact on mitigating fraud and raising public awareness. Although individual sureties remain in business, NASBP's successful support of amendments to the National Defense Authorization Act of 2016 will significantly tighten controls over assets pledged by individual sureties on future federal projects.


Morris C. Sears

Our industry must remain vigilant and redouble its efforts to educate the surety bond market about the dangers con artists present. Although individual surety abuse has taken a large hit over the past few years, it is certain to morph into new and more creative schemes.

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EJCDC
ENGINEERS JOINT CONTRACT DOCUMENTS COMMITTEE

Guide to 2016 EJCDC® Design-Build Family of Documents

SURETY PROFESSIONALS AND their contractor clients will want to make note that the Engineers Joint Contract Documents Committee has released the new EJCDC® Design-Build Family of Documents, which includes nine new and seven revised documents.

New provisions governing the design-builder's submittals to the owner are now flexible and allow the owner a level of input and control over the submittals process. Coordination of separate contracts, claims, disputes, and payment procedures are clearly outlined. The documents also provide an industry-first optional provision for defining risk allocations due to weather-related delays. In addition, the documents outline responsibilities for professional liability through a complete update of insurance requirements. Provisions governing changes due to differing site conditions, hazardous environmental conditions, and responsibility for underground facilities have been clarified as well.

NEW D-110	**Guide to Request for Qualifications—Design-Build Project**	The industry's first document for procuring services of a DB; includes notes to guide drafter of a project-specific RFQ document; may be used for both procuring a DB only on basis of qualifications (such as is normally done for "progressive" DB) or as the first (prequalifications) of a two-step procurement process.
NEW D-111	**Guide to Request for Proposals—Design-Build Project**	The industry's first document for procuring services of a DB; includes notes to guide drafter of a project-specific RFP; for both procuring a DB via a one-step process (in which submitted proposal is typically required to include qualifications, a technical proposal, and a price proposal) or as the second (following prequalifications) of a two-step procurement process (typically involving submittal of a technical proposal and a price proposal).
NEW D-425	**Price Proposal Form—Design-Build Project**	The industry's first form for transmitting to prospective proposers for submitting uniformly formatted price proposals; for proposals that have a pricing component.
D-500	**Agreement between Owner and Owner's Consultant**	For Owner's retention of the services of a design professional consultant that will assist Owner in preparing DB procurement documents (RFQ, RFP, price proposal form), DB conceptual documents, and project's other contract documents. Consultant may assist Owner in evaluating and selecting DB. Offers option for scope of Owner's Consultant's services.
D-505	**Agreement between Design-Builder and Engineer**	Subcontract between DB and Engineer, where Engineer serves as DB's principal design professional for project.
NEW D-512	**Agreement between Owner and Design-Builder for Progressive Design-Build**	Owner retains DB based largely on qualifications and approach because project is not yet well-defined; parties agree on price of final design and construction when project definition is sufficiently far advanced; a larger, more-complex Agreement than either D-520 or D-525.

D-520	**Agreement between Owner and Design-Builder (Stipulated Price)**	Used when project's scope is sufficiently defined at time contract is signed to enter into a binding agreement on price, where basis of compensation is lump sum, unit prices, or a combination thereof.
NEW D-523	**Construction Subcontract for Design-Build Project**	Flexible and used where basis of compensation paid to Sub is either lump sum, unit price, or cost-plus-a-fee, and may be used either to subcontract entire construction to GC, or individual trade subcontracts; replaces D-521, D-526, and D-750.
D-525	**Agreement between Owner and Design-Builder (Cost-Plus)**	Used when project's scope is sufficiently defined at the time contract is signed to enter into a binding agreement on price, where the basis of compensation is cost-of-the-work plus a fee—either with or without a GMP; new in this edition is an exhibit that sets forth types of services and construction eligible for compensation.
NEW D-580	**Teaming Agreement to Pursue Joint Business Opportunity for Design-Build Project**	Teaming agreement between DB and its principal design professional partner; establishes exclusivity of team, so that partners cannot also support a competitor's proposal without knowledge and consent of their teammate. Structured to address: (1) pre-award design scoping and (2) Engineer compensation (if any) for its pre-award design effort; addresses Engineer's potential liability for quantity-related claims arising from pre-award design service performed under Teaming Agreement; includes an optional aggregate limitation of liability provision; has robust termination provisions; contemplates use of either EJCDC D-505 (Design-Builder-Engineer Agreement) or an attached "term sheet" to define post-award contracting expectations, mitigating potential for "bait and switch" on eventual contractual terms available to Engineer.
D-610	**Design-Build Performance Bond**	Update of industry's first performance bond form specific to DB project delivery.
D-615	**Design-Build Payment Bond**	Update of industry's first payment (material and labor) bond form specific to DB project delivery.
NEW D-620	**Design-Builder's Application for Payment**	For administering progress payments to DB; includes integrated worksheets for payment summary, schedule of values for lump sum work, schedule of values for unit price work, and a stored materials summary.
D-700	**Standard General Conditions of the Contract between Owner and Design-Builder**	The cornerstone of EJCDC's Design-Build Documents. Fully revised, updated, and organized to address all major areas for proper, clear allocations of risk and responsibility between parties to a DB contract. For allocating basic duties and responsibilities between the Owner and DB.
NEW D-800	**Guide to the Preparation of Supplementary Conditions (Design-Build)**	Industry-first guide to preparing comprehensive Supplementary Conditions for use with D-700; includes model language, detailed notes, guidance language. Similar to C-800, fully coordinated with D-700 (2016).
NEW D-940	**Work Change Directive—Design-Build Project**	Authorizes changes in Owner/DB contract before parties have reached agreement on the effect on price, time, or both.
NEW D-941	**Change Order—Design-Build Project**	Authorizes changes in Owner/DB contract, including changes to price, time, or other provisions of the contract. Specific to DB project delivery.

EJCDC is comprised of the American Society of Civil Engineers, the National Society of Professional Engineers, and the American Council of Engineering Companies. For more information about EJCDC documents, visit www.ejcdc.org or contact Linda Yelton of the EJCDC at linda@ejcdc.org or 703.403.4812.

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[1]Affirmed April 2014

[2]Nationwide Mutual Insurance Company®, 2015, *http://www.fms.treas.gov.*

Coverage is provided by Nationwide Mutual Insurance Company® and affiliated companies.

[3]Standard and Poors May 2014

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