Don't Be a Victim of Fraud: Verify the Surety and Its Bonds

Introduction

A surety bond is a three-party contract in which the surety promises to answer for the debt or default of another. The party primarily liable is called the principal, and the party protected by the bond is called the obligee. The principal can select the surety and pay for the bonds in the first instance, although the cost is included in the contract price and is reimbursed by the obligee.

On public construction projects, three types of bonds are generally required--a bid bond, a performance bond, and a payment bond. A bid bond guarantees that, if the contract is awarded to the principal, the principal will execute the contract and provide the required performance and payment bonds. The performance bond guarantees to the owner that the contractor will complete the contract in return for payment of the contract price. The payment bond obligates the principal and surety to pay certain laborers and material suppliers for labor and materials furnished for the contract.

Although not required by law in most jurisdictions, the prime contractor often protects against subcontractor default by requiring the subcontractor to provide performance and payment bonds. Thus, the prime contractor will be the principal on the performance bond protecting the owner, but the prime contractor will be the obligee on performance and payment bonds furnished by its subcontractors.

The role of the surety in the construction process is based on the financial standing of the surety. A surety that is not itself financially sound cannot add to the credit standing of its principal. Surety is regulated as a type of insurance, and to some extent a subcontractor can depend on state insurance departments and, for federal projects, the United States Department of the Treasury, to perform financial due diligence.

Although most bonds issued are legitimate bonds, history suggests that a prudent contractor or subcontractor should take steps to assure that the bond will, in fact, provide the promised protection. The time to verify that a surety is genuine is before signing the bond.

Red Flags for Fraud and Due Diligence

A long history of fraudulent bonds has shown certain recurring "red flags" that should cause further investigation. As discussed below, public information is readily available on sureties; and an experienced surety bond producer can provide guidance on whether the available documents and information seem out of the norm of surety business practices and can help spot potential "red flags." Performing due diligence and checking with industry professionals can avoid the disaster of relying on a bond only to find later that the surety does not exist and is unable to pay its obligations, including returning a premium paid to the surety for bonds rejected by an obligee. At a minimum, contractors and subcontractors should confirm that the surety is what it appears to be and is authorized to write surety insurance in the applicable jurisdiction.

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Corporate Sureties

In the United States, almost all surety bonds are written by companies regularly engaged in the business of acting as a surety insurer. Surety companies typically are authorized and qualified to do business where they are domiciled and in the jurisdiction where the bond is issued. Contractors and subcontractors should always check with the state insurance commissioner to determine if the surety company is admitted to write surety bonds in the jurisdiction, paying particular care to ensure that the name of the surety company is an exact match for the name of the admitted surety company. Most states maintain lists of admitted insurance companies on the web site of the state insurance commissioner.

There are instances in which the supposed surety on a worthless bond has a very similar name to a well-known, established surety company. The use of a name very similar to that of an established insurer is one recurring red flag in connection with surety bonds. Some of these alleged surety companies maintain web sites that should be carefully checked for what they are saying, and not saying, about the company. Examples are: the absence of information on the states in which it is admitted to write surety or insurance business, its A.M. Best rating, or its U.S. Treasury certificate of authority. A red flag that should cause concern is incorporation in an overseas jurisdiction with lax or unknown regulatory requirements. A useful check is an Internet search on any officers identified on the web site.

Surety companies wishing to write Miller Act bonds on federal construction projects must have a certificate of authority from the U.S. Department of the Treasury. The Miller Act is a federal law that requires performance and payment bonds on all public works contacts let by the United States if the contract amount exceeds $100,000. The Treasury Department conducts a financial review of the company and sets a single bond "underwriting limitation" for the surety. The list of certified surety companies approved to write bonds on federal projects, known as Department Circular 570, or the Treasury List, or the T-List, is posted at www.fms.treas.gov/c570/c570_a-z.html. This web site also includes a listing of the phone numbers of state insurance departments, which can provide further information about surety companies admitted in that jurisdiction.

Surety companies also are rated by private rating organizations. These third-party rating organizations compile financial information and assess financial strength and size. Rating organizations, including A.M. Best Company, provide useful information in assessing the financial capacity of insurance companies.

The fact that a surety company is genuine and solvent is not enough if the bond was not authorized by that company. There have been a number of cases in which a party has been convicted of fraud or pled guilty to fraud in furnishing bonds that seemed to be but were not issued by legitimate sureties.

Individual or Personal Sureties

State insurance laws require individuals, not just companies, who wish to act as a surety on bid, performance, and payment bonds to obtain a license or certificate of authority from the state insurance department. A major exception is the federal government, which gives contracting officers the discretion to accept such bonds from individuals if the bonds are backed by cash or cash equivalents equal to the amount of the bonds in escrow or a deed of trust on real property sufficient to secure the bond. One state, Maryland, has a law, set to expire in 2014, that allows individuals to act as sureties on public construction contracts on terms similar to the federal requirements.

There have been a number of cases in which an individual surety that issued Miller Act performance and payment bonds on federal contracts was found to be false and the assets to secure the bonds were insufficient or non-existent. Bond fraud usually involves false representations by an individual surety about the existence and availability of the assets supporting the bond. In many such cases, the subcontractors and the suppliers that the surety bond was supposed to protect were left with no remedy for non-payment.

Unfortunately, there is no central authority, such as the U.S. Department of the Treasury, to investigate proposed individual surety bonds. They are evaluated by the contracting officer during the course of a particular procurement. The contracting officer is responsible for determining the acceptability of the individual surety and the sufficiency of the pledged assets backing the bonds. This places a significant burden on federal contracting officers, who are involved in many tasks concerning the procurement and who have differing levels of knowledge regarding surety bonds.

Sometimes contracting officers are fooled by documents that appear to pledge sufficient surety assets but are not backed by real assets that meet federal requirements. Bonds unsecured by real assets not only put taxpayers at risk but also endanger subcontractors and suppliers on federal projects. The Miller Act payment bond is the sole remedy available to unpaid subcontractors or suppliers on a federal project. Individual surety bond fraud has led to substantial losses for the federal government and for many contractors, including small and minority contractors participating as subcontractors and suppliers on federal projects.

Conclusion

On any construction project, a subcontractor or supplier considering extending credit in reliance on a payment bond should obtain a copy of the bond before agreeing to extend the credit. If the bond is not from a known surety, the supplier or subcontractor should perform its due diligence. It should verify that the surety is an admitted insurer in the state involved and, for federal projects, that the corporate surety is on the U.S. Department of the Treasury List of sureties acceptable to the United States. If the subcontractor or supplier is not confident in the bond, it should verify that the bond was authorized by the surety.

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There is a long, unfortunate history of fraud in connection with surety bonds. Anyone can avoid becoming the victim of such fraud, however, by taking steps to verify the legitimacy of the surety and to ensure that the surety authorized the bond.