



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
INVESTIGATIONS DIVISION

DATE: September 28, 2007

TO: Frank J. Lalumiere
Director
Office of Surety Guarantees

FROM: Daniel J. O'Rourke [FOIA ex. 6]
Assistant Inspector General
for Investigations

SUBJECT: Advisory Memorandum (Report #7-32)
[FOIA ex. 4]

During a recent investigation, the Office of Inspector General (OIG) identified problems that occurred when a surety selected a replacement contractor to finish the contracts on which the original contractor defaulted. Accordingly, we believe that the Small Business Administration (SBA) should require sureties to exercise greater due diligence before selecting replacement contractors.

BACKGROUND

[ex. 4] an SBA preferred surety, bonded several contracts to be performed by [ex. 4] SBA guaranteed those bonds. [ex. 4] defaulted on its contracts, and [ex. 4] hired [FOIA ex. 6] as the replacement contractor to finish two of [ex. 4] contracts at the [ex. 4] Washington.

[ex. 6] obtained payments from [ex. 4] based on assertions that it had paid its subcontractors and suppliers from past payments and would use the current payment to pay its subcontractors and suppliers for current work. In fact, [ex. 6] took the approximately \$200,000 it was paid and never made any payments to subcontractors and suppliers.

[ex. 6] president used the funds received from [ex. 4] to pay down [ex. 6] line of credit and did not pay subcontractors or suppliers as required by its contract with ICW and as he certified he would. However, [ex. 6] pre-existing line of credit required [ex. 6] to deposit all receivables in order to pay it down. Only then could [ex. 6] draw against the line of credit to pay subcontractors and suppliers. Because [ex. 6] had exhausted its credit line, it could not make such draws. [FOIA ex. 7E]

NO DUE DILIGENCE CHECKS WERE REQUIRED

Although [FOIA ex. 7E] an operational weakness was identified. The investigation found that [ex. 4] did not conduct any due diligence on [ex. 6] as the replacement contractor. According to an [ex. 4] analyst, [ex. 4] was losing thousands of dollars per day on penalties for [ex. 4] non-performance and needed to hire a replacement contractor to finish the bonded jobs as soon as possible. [ex. 6] seemed the logical choice, particularly because [ex. 4] project superintendent had gone to work for [ex. 6] and knew the requirements to complete the job.

An SBA official confirmed that, once the original contractor defaulted, the surety had to ensure the contract was completed or would have to pay penalties. Although SBA does not require extra underwriting on the replacement contractor's qualifications or bonding potential, the Agency's bond guaranty still covers the completion of the work, even by the replacement contractor. SBA will pay 70% of the entire loss on these bonds, including any losses incurred as a result of the replacement contractor's default. Yet, it is the individual surety's underwriting policy, and not SBA, which determines how much research is done on the replacement contractor.

CHARACTER AND REPUTATION OF THE REPLACEMENT CONTRACTOR

The problems with [ex. 6] were preventable because information was readily available about prior performance and financial problems. According to an [ex. 4] staff member, [ex. 4] began defaulting on contracts in August 2003, and on September 29, 2003, [ex. 4] notified [ex. 4] that it had no funds left to pay its subcontractors. At that time, [ex. 4] tried working with [ex. 4] to complete the contracts while [ex. 4] handled all of the finances. Thus, [ex. 4] did not immediately seek a replacement contractor. When it became apparent that [ex. 4] needed to find a replacement contractor to finalize the work, [ex. 4] was incurring daily monetary penalties from contract owners due to the non-completion of the contracts.

According to an [ex. 4] official, once [ex. 4] discovered that [ex. 6] had not paid its subcontractors, [ex. 4] received notice from the Ohio Casualty Group that [ex. 6] did the same thing on one of its contracts at the [ex. 6] (Washington) [ex. 6] thus costing Ohio Casualty \$79,000.

Our investigation found that a civil judgment was levied against [ex. 6] in [ex. 6] Washington, on [ex. 6] in the amount of \$20,755. In addition, the Washington State Department of Licensing website, located at <https://fortress.wa.gov/lni/bbip/>, shows that as of June 24, 2003, at least 10 companies had levied complaints against [ex. 6] with claims totaling \$255,731.85.

If SBA had required [ex. 4] to conduct due diligence on replacement contractors, [ex. 4] could have found these claims prior to hiring [ex. 6] as a replacement on the [ex. 4] contracts. [ex. 4] was not interviewed regarding this information to determine if this would have made a difference to [ex. 4] in its hiring decision. However, it is information [ex. 4]

usually uses in its decisions to bond contractors and is requested on the applications contractors complete for bonding.

Moreover, SBA Standard Operating Procedure 50 45 2, The Surety Bond Guarantee Program, Chapter 4, section 3, discusses the importance of the contractor's character and reputation. It states that the company's character and reputation are deemed good if each owner of 20 percent or more of its equity has good character. Good character is absent if "A final civil judgment has been entered stating that the person committed a breach of trust or has violated a law or regulation protecting the integrity of business transactions or business relationship."

It is not immediately clear whether the judgment levied in [ex. 6] involved a breach of trust or violation of law or regulation regarding business transactions. However, the surety could have easily obtained the lawsuit and claim information within a few minutes from the Washington State Department of Licensing website and the surety or its attorney could then have followed up by reviewing the case. The lawsuits would also have been discovered if the surety or its attorney had quickly researched the company on Westlaw or Lexis/Nexis. As seen above, there were several lawsuits and claims filed against [ex. 6] prior to [ex. 4] September 29, 2003, notice of default.

CONCLUSIONS

Researching the contractor through the relevant state government's licensing authority's website or public databases such as Westlaw or Lexis/Nexis are ways to determine whether a particular replacement contractor should be hired. In addition, asking the replacement contractor specific questions and comparing those answers with the surety's research would also determine whether a particular replacement contractor should be hired.

Several existing SBA documents ask applicants questions concerning their character and reputation. If sureties were required to ask replacement contractors *some* of these questions, as outlined below, this would provide basic information, as well as serve as a basis for criminal and/or civil prosecution in the event of contractor false statements. If the replacement contractor disclosed outstanding judgments, liens, or a criminal history, the surety could then determine whether the replacement contractor had the character, reputation, and financial ability to complete the work.

We recognize that time is of the essence whenever a surety needs a replacement contractor and that it may be unreasonable to expect the same level of detailed information as the original contractor would have provided. Thus, the following recommendation is intended to balance the need for accountability and loss prevention with the need for efficiency.

RECOMMENDATION

We recommend that the Director, Office of Surety Guarantees (OSG), require a surety to perform one or the other of the following actions before hiring a replacement contractor:

- a. Ensure that the prospective replacement contractor's work on a project is covered by a **non-SBA guaranteed** bond, or
- b. Exercise due diligence when selecting a replacement contractor, as outlined in Appendix I.

MANAGEMENT'S COMMENTS

We provided you with a draft report, which we discussed with you. You advised that you will review processes to limit SBA's financial liability on replacement contractors, including the two recommended alternatives, and will implement such a process.

OIG ANALYSIS OF MANAGEMENT'S COMMENTS

Your comments are responsive to our recommendations. We appreciate the cooperation of your office during this effort. If you have any questions, please feel free to contact me on (202) 205-[FOIA ex. 2]

Appendix I

Due Diligence Steps to be Performed by a Surety

If a surety does **not** ensure that the replacement contractor's work on a project is covered by a **non-SBA guaranteed** bond, then the surety should request the following information before selecting a replacement contractor.

1. Research the performance and legal records of a prospective replacement contractor through the relevant state licensing authority and/or the Lexis/Nexis, Westlaw, or similar databases.
2. Ask the prospective replacement contractor the following before hiring it:
 - a. I do/do not have an SBA Loan. I did/did not have a previous SBA Loan. I have an SBA loan through the SBA Office in _____, with a balance of \$ _____ as of (date) _____. Loan no. _____.
 - b. I am/am not an SBA Section 8(a) Qualified Contractor.
 - c. I have/have not received a prior SBA bond guarantee, either under this trade name or another. If under another trade name, specify trade name, city, state, and date.
 - d. Have you ever defaulted on any previous surety bonds (SBA or other) either under this contracting concern's trade name or any other concerns of which you have been a principal? If yes, provide detailed particulars including the name of the surety.
 - e. List all of the following for the principal, applicant, or any of its affiliates:
 - SBA loan applications pending;
 - Federal debt, including SBA loans, whether current, past due, charged off, or paid in full.
 - f. List all principals, partners, officers, directors, and all holders of outstanding stock –100% of ownership must be shown.
 - g. Have you or any officer of your company ever been involved in bankruptcy or insolvency proceedings? If so, please provide the details.
 - h. Are you or your business involved in any pending lawsuits? If yes, please provide the details.

- i. Do you or your business have any outstanding judgments? If yes, please provide the details.
3. Have the prospective replacement contractor fill out SBA Form 912 (Statement of Personal History), and ask if any of the principals are currently under investigation for any crimes.
4. Ask the prospective replacement contractor to certify that the principal and the contractor are current on all federal, state and local taxes, including, but not limited to, income taxes, payroll taxes, real estate taxes and sales taxes.
5. Ensure that the following admonition be on any document containing the above questions:

“If you knowingly make a false statement to the SBA or to the surety in connection with an SBA-guaranteed bond, you can be fined up to \$10,000 and/or imprisoned for not more than five years under Title 18 USC 1001.”