U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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Congressional Committees

Small Business Contracting: Surety Bond Waivers for Construction Contracts

Surety bonds—which generally apply to construction contracts—are guarantees issued by providers, such as individuals or surety companies, to ensure that projects will be completed as required and that suppliers and subcontractors will be paid if a bonded prime contractor defaults.[1] The House report accompanying the National Defense Authorization Act for Fiscal Year 2017 included a provision for us to report on the use of surety bonds in connection with federal contracts with small businesses.[2] This report identifies (1) the requirements for obtaining surety bonds, (2) how often surety bonds are waived at selected agencies, and (3) the whistleblower process for reporting fraud related to surety bonds at selected agencies.

To select the federal agencies for this review, we analyzed data from the Federal Procurement Data System – Next Generation (FPDS-NG) to identify those agencies that had the largest total obligations on construction contracts awarded to small businesses between fiscal years 2012 to 2016: the Department of Defense (DOD) and the Department of Veterans Affairs (VA). In addition, we selected the Department of State (State) because of its experience with construction contracts performed in foreign countries. Combined, these three agencies accounted for 81 percent of total obligations on federal construction contracts with small businesses from fiscal years 2012 to 2016. To assess the reliability of the FPDS-NG data, we reviewed relevant documents and data quality summaries. We determined that the FPDS-NG data were sufficiently reliable for the purposes of selecting federal agencies with the highest small business construction obligations.

To address our objectives, we reviewed federal surety bond requirements in legislation and relevant Federal Acquisition Regulation (FAR) provisions and reviewed data collected in FPDS-NG. We interviewed officials from DOD, VA, and State, including policy and contracting officials, and officials responsible for construction and small business initiatives. We also reviewed agencies' policies and procedures related to surety bond requirements. We met with officials from the Small Business Administration (SBA) for subject matter expertise regarding government surety bond requirements for small businesses and the Surety Bond Guarantee Program. To get an industry perspective regarding the frequency of surety bond waivers for construction contracts, we met with representatives from the National Association of Surety Bond Producers, the Surety and Fidelity Association of America, and the Associated Builders and Contractors. Finally, we reviewed federal and agency whistleblower processes and

[1]A surety is an individual or corporation legally liable for the debt, default, or failure of a principal to satisfy a contractual obligation. FAR §2.101.

[2]H.R. Rep. No. 114-537 (2016).

procedures, and contacted officials from the Offices of Inspector General (OIG) at DOD, VA, and State.

We conducted this performance audit from February 2017 to August 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

Federal law requires contractors of any size performing federal construction contracts that meet certain cost thresholds to obtain payment and performance bonds guaranteed by a surety, but in limited circumstances these requirements may be waived. At the three selected agencies, officials stated, and our research confirms, that there is no readily accessible source of data on the extent to which such surety bonds for federal construction projects are waived. The officials we interviewed also stated, however, that given the importance of the statutory requirement for surety bonds, instances of waivers are rare. State and DOD officials provided some examples in which the requirements were waived for construction contracts in foreign countries, which is one of the specific circumstances appropriate for a waiver. Agency officials at the selected agencies said they would use their respective whistleblower laws and procedures to review any reported allegation of surety bond fraud.

Requirements for Obtaining Surety Bonds

Federal law requires contractors executing federal construction contracts that exceed $150,000 to obtain two types of surety bonds: (1) payment bonds, which guarantee that suppliers and subcontractors will be paid for material and work performed under the contract, and (2) performance bonds, which guarantee that the contractor will perform the contract in accordance with its terms and conditions.[3] This law, which is sometimes referred to as the Miller Act, allows for these surety bond requirements to be waived under certain conditions, such as when the contracting officer determines it is impracticable for the contractor to furnish a bond for work performed in a foreign country, or for specified DOD and Department of Transportation cost-reimbursement construction contracts. In addition, we previously found that small businesses can have difficulty obtaining surety bonds due to their possible lack of financial strength and experience.[4] In order to assist small businesses in meeting bonding requirements, the SBA administers the Surety Bond Guarantee Program. Under the program, SBA guarantees bonds issued by surety companies on behalf of contractors. If a default occurs, SBA reimburses the surety company up to 90 percent of incurred losses.

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[3]40 U.S.C. §3131(a)(b) In addition to performance and payment bonds, federal regulation also sets requirements for bid guarantees, including bid bonds, which are another form of surety bond that assures the bidder on a contract will not withdraw its bid before acceptance and furnish the required performance and payment bonds if awarded the contract. In addition, for construction contracts valued between $35,000 to $150,000, the contracting officer must obtain from the contractor at least two of the following types of payment protections: a payment bond; an irrevocable letter of credit; a tripartite escrow agreement; certificate of deposit; U.S. bond or note; and certified or cashier's checks, bank drafts, money order, or currency. FAR §28.102-1(b)(1)

[4]GAO, *Small Business: Construction Firms' Access to Surety Bonds*, GAO/RCED-95-173FS (Washington, D.C.: June 26, 1995).

The FAR includes provisions that implement the surety bond requirements in the Miller Act, including when the requirements can be waived. DOD, VA, and State have supplemental acquisition regulations related to surety bond requirements. For example, DOD's Defense Federal Acquisition Regulation Supplement (DFARS) includes additional payment and performance protection requirements for fixed-price construction subcontracts over $35,000 that are under a cost-reimbursement prime contract.[5] In another example, the supplemental guidance for the Naval Facilities Engineering Command (NAVFAC)—which plans, builds, and maintains naval facilities—adds that only a top-level contracting officer may issue a waiver for construction contracts performed in foreign countries. VA's supplemental regulation provides that an additional clause must be included in a contract with a payment or performance bond.[6] State's supplemental regulation identifies the official with authority to waive the bid guarantee requirement when a payment or performance bond is required.[7]

Selected Agencies Do Not Track Instances of Surety Bond Waivers, but Agency Officials Report That Waivers Are Rare

According to DOD, VA, and State officials, there is no tracking mechanism or data source to identify how often surety bonds are waived. These officials added that a waiver to the surety bond requirement would be recorded in the contract file. We also confirmed that FPDS-NG, the federal government's procurement database, does not include information related to waivers of surety bond requirements.

Contracting officials from DOD, VA, and State noted that based on their experience and observations, surety bond waivers on construction contracts are rare. At DOD, a U.S. Army Corps of Engineers official, who reached out to 12 regional contracting offices, said that he and the regional officials could not recall even one instance in which surety bond requirements for a construction contract were waived. Although federal law specifically allows DOD to waive surety bond requirements for specified cost-reimbursement construction contracts, most DOD construction contracts are fixed-price. Thus, the opportunity to apply this waiver is rare. FPDS-NG data show that from fiscal years 2012 to 2016, only 3 of over 6,000 DOD construction contracts awarded to small businesses were cost-reimbursement contracts. Officials from three VA operational offices that award construction contracts stated that they do not issue surety bond waivers. One VA official said that he could not think of a single example of waiving a surety bond requirement in almost 30 years of experience in construction contracting at the VA and other federal agencies. Further, a representative from the Surety and Fidelity Association of America—whose members include surety providers to government contractors—said that the association likely would have heard from its members if federal agencies were waiving surety bond requirements, but could not recount any instances of federal agencies using such waivers. An Associated Builders and Contractors representative, whose members include federal construction contractors, acknowledged that they have not heard from their members about the issue of waiving surety bond requirements.

Representatives from one association we spoke with—the National Association of Surety Bond Producers, which represents surety agents and brokers—said that they are aware of instances in which surety bond requirements are being waived on federal foreign construction contracts

[5] DFARS §228.102-1

[6] The clause is related to bond premium adjustments. See VA Acquisition Regulation §828.1.

[7] Department of State Acquisition Regulation §628.1.

performed overseas. Officials from State and NAVFAC confirmed that they have used waivers for overseas construction contracts in some circumstances. As previously noted, the Miller Act permits waiving these requirements if the contracting officer determines it is impracticable for the contractor to obtain surety bonds. State officials explained that although they generally require bonds, they began to waive the requirements on foreign construction contracts for small businesses starting in 2008 because few contractors could obtain the requisite bonds at that time.[8] A State contracting official said that in order to continue contracting with small businesses and still provide some protection to the government, the agency implemented a system in which it would withhold a percentage of progress payments to the contractor until certain project thresholds were met.[9] State officials noted that it has become easier for small businesses to obtain bonds in recent years, and thus they are not issuing waivers as often. In addition, NAVFAC officials said that while they require payment and performance bonds for all domestic construction contracts and most overseas contracts, a contracting office or activity has in rare cases waived either one or both of the payment and performance bond requirements for construction contracts in foreign countries. Decisions on waivers, they told us, are based on the risk, visibility, or complexity of the contract.

Surety Bond Fraud May Be Reported through Federal Whistleblower Processes and Procedures, but Officials at Selected Agencies Note Surety Bond Fraud Is Rare

Surety bond fraud is one of many types of fraud that can be reported to federal whistleblower hotlines, but surety bond fraud cases reported through the hotlines for our selected agencies are rare. An example of surety bond fraud is when a surety bond issuer provides fraudulent information about the assets available to support the bond. According to DOD, VA, and State officials, they would process whistleblower hotline calls related to surety bond fraud the same as other types of fraud, such as claiming false reimbursement costs for government-related travel. All cases are reviewed by the agencies' OIGs and potentially forwarded to the appropriate office. At DOD, for example, a DOD OIG official told us that if the reported surety bond fraud claim is related to an Army contract, it would be forwarded to the appropriate Army officials. If the claim represents a broader issue, then it may be forwarded to the Defense Criminal Investigative Service. According to OIG officials, whistleblower cases related to surety bond fraud are rare. A DOD IG official who, at our request, performed a search of the database that tracks whistleblower hotline cases identified only one case since 2011 that was related to surety bond fraud. An official who performed a similar search for the VA's hotline identified only three instances of calls potentially related to surety bond fraud from fiscal years 2012 to 2016. A State OIG official could not find any instances of surety bond fraud in State's whistleblower data system.

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[8]State officials attributed this to the recession in 2008 and the surety bond market not being willing to take the risk on these businesses. Further, SBA officials said it could also be difficult to obtain surety bonds for contracts performed outside the United States due to the legal complexities inherent in contracting in other countries.

[9]FAR §32.103 addresses retaining a percentage of progress payments for construction contracts. We did not assess State's use of retainage provisions in this report.

Agency Comments

We are not making any recommendations in this report. The Departments of Defense, Veterans Affairs, State, and the Small Business Administration had no comments on a draft of this report.

We are sending copies of this report to the appropriate congressional committees, the Secretaries of Defense, Veterans Affairs, State, and the Administrator of the Small Business Administration. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff has any questions about this report, please contact me at (202) 512-4841 or woodsw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report include Tatiana Winger, Assistant Director; Andrew Burton; Stephanie Gustafson; Julia Kennon; Sylvia Schatz; and Matt Shaffer.

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