



**U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, D.C. 20416**

<b>MEMORANDUM AUDIT REPORT</b>
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<b>Issue Date: July 28, 1999</b>
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<b>Report Number: 9-13</b>
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**TO:** Robert J. Moffitt, Associate Administrator, Office of Surety Guarantees  
/s/ Original Signed

**FROM:** John E. Dye, Acting Assistant Inspector General for Auditing

**SUBJECT:** Audit of Gulf Insurance Group (Gulf)

We completed an audit of Gulf Insurance Group, based in New York, NY. Gulf has participated in SBA's Surety Bond Guarantee Program as a prior approval surety since March 31, 1994. As of June 30, 1998, Gulf had issued 1,979 SBA guaranteed bonds valued at approximately \$402 million. Gulf contracted underwriting and claims processing to Midwest Indemnity Corporation and Viceroy Management, Incorporated, respectively.

#### **AUDIT OBJECTIVES AND SCOPE**

The audit objectives were to determine if: (1) Gulf complied with SBA's and its own policies and procedures in applying for bond guarantees for which SBA paid claims; (2) claims and expenses paid by SBA were allowable, allocable, and reasonable; and (3) fees due SBA were accurately calculated and remitted in a timely manner. SBA records showed Gulf had 63 bonds in default with claims totaling approximately \$4.1 million from October 1995 through June 1998. To answer the audit objectives, we judgmentally selected for review the 10 bonds with the largest dollar amount of claims. The 10 bonds had claim payments totaling about [FOIA ex. 4] or [FOIA ex. 4] of the dollar value of all claims during the period. See Attachment 1 for a listing of the sampled bonds.

Fieldwork was performed from August 1998 through December 1998. We reviewed Gulf's underwriting and claims files, interviewed SBA and Gulf officials, and reviewed Gulf's procedures for the remittance of fees. The audit was conducted in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

For the sampled bonds, Gulf did not always comply with SBA's policies and procedures in applying for bond guarantees, claiming reimbursement for expenses, and remitting recoveries. As a result, SBA should be reimbursed \$142,284 for its share of claims paid under an improper bond guarantee and expenses paid that were unallowable. Fees due SBA were accurately calculated and timely remitted.

### **Finding 1: Gulf's Underwriting Required Strengthening**

Gulf did not always comply with SBA's requirements for issuing SBA guaranteed bonds. A review of 10 defaulted bonds disclosed that 1 bond was executed after work under the contract had started without SBA's approval. Gulf also submitted bond applications to SBA in excess of the number allowed by a SBA bonding line. For the bond executed after work had begun, we questioned \$139,655, SBA's guaranteed portion of claims reimbursed.

#### ***Work Started Prior To Bond Execution***

##### Space Construction

Gulf, without SBA's approval, executed a bond after work under the bonded contract had started and, in applying for SBA's bond guarantee, misrepresented on Form 994B that work had not started. Although payment and performance bonds were not issued until March 29, 1996, schedules of uncompleted work showed that costs were incurred on the project as early as February 6, 1996. An application for payment in the amount of \$27,362, showed that the costs were incurred for clearing, grading, and construction of a retaining wall. Title 13 CFR 115.19(f) (1996 edition) states that SBA is not liable under a prior approval agreement if the bond was executed after work under the contract had begun. Title 13 CFR 115.19(b) (1996 edition) states that SBA is not liable under a prior approval agreement if the surety obtained the agreement by material misrepresentation, including the making of an untrue statement.

Gulf stated that contractors typically incur start-up costs prior to beginning work on projects and that even without receipt of a SBA Form 991, the local SBA office accepts this practice. Gulf also stated that their agent was in frequent contact with SBA and that SBA was made aware that work had started by verbal conversation and on schedules of uncompleted work. Gulf further stated that the principal had not been paid for any of the work.

The Senior Surety Bond Specialist at SBA's Atlanta Regional Office informed the auditors that it is not SBA's standard practice to approve a bond when start up costs have been incurred on the project without receipt of an SBA Form 991. The SBA

representative further stated that Gulf would have been required to submit a SBA Form 991 for approval. As a result of the above circumstances, SBA guaranteed an ineligible bond and as of January 29, 1999, SBA's share of the losses totaled \$139,655.

### ***Bonding Line Terms Not Followed***

[FOIA ex. 6] Industries, Inc.

Gulf submitted bond applications in excess of the number allowed by a SBA bonding line issued on April 7, 1994. The bonding line required that the principal not have more than six outstanding contracts at one time. At the time the bonding line was issued, the principal had eight outstanding contracts. Between April 7, 1994 and May 20, 1994, the underwriting agent submitted nine additional bond applications, violating the bonding line's contract limitation term. Gulf stated that three of the initial eight outstanding contracts were for emergency repair work which they do not believe should be given the same weight as fixed-price contracts. Gulf also stated that SBA may have knowingly waived the contract limitation, as SBA approved each of these bonds with full knowledge of [FOIA ex. 6] work on hand. An official at the SBA office that approved the bonds informed the auditors that the contract limitation was not waived for [FOIA ex. 6]. In any event, Gulf stated they would take necessary action to ensure that SBA's bonding line limits are strictly enforced.

### **Recommendations:**

We recommend the Associate Administrator, Office of Surety Guarantees, notify Gulf to:

- 1A. Remit \$139,655 to SBA for its share of the losses on the Space Construction bond and not submit any further claims, as liability will be denied due to the commencement of work prior to bond execution.
- 1B. Revise current underwriting procedures to ensure SBA bonding line terms are followed.

### **Finding 2: Gulf Did Not Always Follow SBA Requirements Related to Claims, Expenses and Recoveries**

In reviewing claims, expenses, and recoveries for the sampled bonds, the auditors determined that Gulf submitted legal expenses that were not allocable to the bonded contract for one bond, remitted salvage to SBA in an untimely manner for two bonds, and pursued indemnification against a principal determined to have no viable assets for another bond. As a result, we questioned \$2,629.

### ***Unallowable Legal Expenses Submitted for Reimbursement***

#### DAB Construction Company

Gulf submitted to SBA and was reimbursed \$2,629 for legal expenses that were not allocable to claims on the bonded contract. Title 13 CFR 115.16(e)(1) (1997 edition) states that loss includes expenses that are specifically allocable to the investigation, adjustment, negotiation, compromise, settlement of or resistance to a claim for loss resulting from the breach of the terms of the bonded contract. Title 13 CFR 115.16(f) states that loss does not include unallocated expenses. The auditors determined that the legal expenses were related to Gulf's research of its agent's underwriting practices with regard to the bond. Gulf agreed that the fees were not directly related to the principal's breach of the contract and stated SBA would be reimbursed for the legal expenses.

### ***Salvage Was Not Submitted To SBA in a Timely Manner***

#### DAB Construction Company and Circle T Construction

Gulf did not timely submit salvage to SBA for two bonded contracts. Title 13 CFR 115.17(b)(2) (1997 and 1998 editions) require that any salvage the surety receives be remitted to SBA within 90 days. Gulf received DAB Construction Company contract proceeds on November 10, 1997 and February 13, 1998, totaling \$13,240, and did not credit this amount to SBA on a Form 994H, "Claim For Reimbursement", until August 24, 1998. Gulf also received Circle T Construction contract proceeds totaling \$11,000 on June 5, 1998, and as of November 2, 1998, had not credited this amount to SBA. As a result, monies due SBA were withheld in error.

Gulf stated that it was standard practice to hold salvage to offset claims being processed and monies owed to Gulf by SBA, and that SBA was aware of this practice. Gulf stated that the Circle T Construction recovery offset claims on a January 6, 1999 billing to SBA. Gulf also stated they have since complied with SBA's November 1998 request that recoveries be submitted separately.

### ***Unjustified Pursuit of Indemnification Against the Principal***

#### Space Construction

Although Gulf determined in December 1997 that the indemnitors did not have any viable assets, an indemnification action was filed against the indemnitors in May 1998. Title 13 CFR 115.34(3)(b) (1998 edition) states that the surety should recommend discontinuance of pursuit when the pursuit of salvage and recovery is neither economically feasible nor a viable strategy in maximizing recovery. Losses

under the subject bond are not being minimized, due to legal costs being expended in this matter.

Gulf stated that the lawsuit was initiated as a result of Gulf's obligation to "pursue all possible sources of salvage, and recovery," as required by Title 13 CFR 115.15(b) and that an action against Space's indemnitors was a viable strategy for recovery of bond losses. Gulf still believes the indemnification action is economically feasible and viable.

### **Recommendations:**

We recommend that the Associate Administrator, Office of Surety Guarantees, notify Gulf to:

- 2A. Remit \$2,629 to SBA for its share of legal expenses related to the investigation of the agent's underwriting practices on the DAB Construction bond.
- 2B. Revise current claims procedures to ensure salvage and recovery is submitted timely.
- 2C. Revise current indemnification procedures to ensure indemnification actions are pursued only when economically feasible.

### **Auditee's Response**

Gulf agreed with our recommendations and stated SBA would be reimbursed for the questioned costs. Gulf's response is included as Attachment 2.

### **SBA Management's Response**

The Associate Administrator, Office of Surety Guarantees agreed to implement our recommendations.

### **Evaluation of Responses**

The comments provided by Gulf and the Associate Administrator, Office of Surety Guarantees are responsive to our recommendations.

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The findings included in this report are the conclusions of the Office of Inspector General's Auditing Division. **The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.**

Please provide us your proposed management decisions for the recommendations within 80 days on the SBA Form 1824, Recommendation Action Sheet. If you disagree with the recommendation, please provide your reasons in writing.

This report may contain proprietary information subject to the provisions of 18 USC 1905. Do not release to the public or another agency without permission of the Office of Inspector General.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Business Development Programs Group at (202) 205- [FOIA ex.2]

Attachments

## SAMPLED BONDS

Sample No.	SBG No.	Gulf Bond No.	Contractor Name	Bond Effective Date
1	[FOIA ex. 2]	5633984	[FOIA ex. 6]	7/14/94
2		5597899	[FOIA ex. 6]	10/11/94
3		5597711	[FOIA ex. 6]	4/25/94
4		5709551	Environmental Safety Consultants	10/9/95
5		5714651	Environmental Safety Consultants	11/30/95
6		5639174	DAB Construction	9/9/94
7		5782670	Space Construction	3/29/96
8		5594234	[FOIA ex. 6]	1/10/94
9		5698000	[FOIA ex. 6]	6/30/95
10		5701696	Circle T. Construction	10/19/95

**Gulf Insurance Group**  
A member of citigroup

RECEIVED  
OFFICE OF INSPECTOR GENERAL  
U.S. SMALL BUSINESS ADMINISTRATION  
JUL 20 1999

July 20, 1999

Mr. Robert J. Moffitt  
Associate Administrator  
Office of Surety Guarantees  
U.S. Small Business Administration  
Washington, D.C. 20416

Dear Mr. Moffitt:

The following is in response to the Office of Inspector General's draft audit report dated July 7, 1999 (copy attached):

**Finding 1: Gulf's Underwriting Required Strengthening**

**Recommendations:**

1A. Gulf will not take issue with the Office of Inspector General's ultimate recommendation and will remit \$139,655 to the SBA for its share of the losses on the Space Construction bond as commencement of work began prior to the execution of the bond. As to the proper documentation of eligible contract bonds, Gulf has now taken all necessary measures to ensure that the proper reporting and documentation of bonds is in accordance with SBA regulations.

1B. Gulf concurs with the Office of Inspector General's recommendation and has therefore already changed underwriting procedures to ensure that bonding line limits set by the SBA are strictly enforced.

**Finding 2: Gulf Did Not Always Follow SBA Requirements Related to Claims, Expenses and Recoveries**

**Recommendations:**

2A. Gulf concurs with the Office of Inspector General's recommendation and will remit \$2,629 to the SBA for its legal expenses related to the investigation of the agent's underwriting practices on the DAB Construction bond.

2B. Gulf concurs with the Office of Inspector General's recommendation and has already taken steps to alter the processing procedures in order to submit billings and recoveries on a timely basis.

2C. Gulf naturally concurs with the Office of Inspector General's recommendation that with any claim, upon an in-depth analysis, time and expense on pursuit of salvage and/or recovery must be economically feasible and viable.

Gulf is very appreciative of the time and effort set forth by the staff at the Office of Surety Guarantees, who provided a thorough and comprehensive training program for our employees. Gulf Insurance Company fully recognizes and will continue to emphasize the importance of compliance to the established SBA regulations and procedures. Gulf will further ensure that Century Surety Underwriters, Gulf's Managing General Agent on this program, will continue to adhere to and administer said regulations and policies. To further ensure compliance, Gulf Insurance Company recommends that Century Surety Underwriters and COP, Gulf's claims administrator, attend the SBA training program in Washington, D.C. for an in-depth review of the SBA's regulations, policies and procedures.

As it appears that all specific issues may now be resolved, we believe the only issue remaining is that some form of agreement and/or release should be drafted memorializing same. To that end, we will begin to draft such a document for your review.

If we can be of further assistance, please do not hesitate to call me at (212)816-0511.

Sincerely,

[FOIA ex. 6]

Spiro K. Bantis  
General Counsel

cc: C. Watson  
L. Minter  
C. Ruboyianes  
J. Cocomazzi  
B. Kelly

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