



US SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
Issue Date: March 31, 1999
Number: 9-10

TO: Robert J. Moffitt
Associate Administrator
Office of Surety Guarantees

/s/ Original Signed

FROM: Peter L. McClintock
Assistant Inspector General for Auditing

SUBJECT: Audit of Contractors Bonding and Insurance Company

The attached Independent Accountant's Audit Report (Attachment 1) presents the results from their audit of Contractors Bonding and Insurance Company (CBIC). The report by Cotton & Company, CPAs, discusses problems related to (1) claimed in-house legal fees, (2) contract splitting, (3) incorrect powers of attorney, and (4) underwriting file retention.

You may release this report to the duly authorized representative of CBIC at your discretion. This report may contain proprietary information subject to the provisions of 18 USC 1905. Therefore, you should not release this report to the public or another agency without permission of the Office of Inspector General.

Please provide us your proposed management decision for each recommendation within 80 days on the attached SBA Forms 1824, Recommendation Action Sheet. If you disagree with the recommendations, please provide us your reasons.

The findings in this report are based on the auditor's conclusions and the report recommendations are subject to review, management decision, and action by your office in accordance with existing Agency procedures for audit follow-up and resolution. Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations at (202) 205- [FOIA ex. 2]

Attachment

COTTON & COMPANY

CERTIFIED PUBLIC ACCOUNTANTS, LLP

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ELLEN P. REED, CPA
MATTHEW H. JOHNSON, CPA

June 19, 1998

U.S. Small Business Administration
Office of Inspector General

BACKGROUND

The Small Business Administration's (SBA) Surety Bond Guarantee Program (SBG) was authorized by the Small Business Investment Act of 1958, as amended. It was created to assist small, emerging, and minority construction contractors. SBA indemnifies surety companies from potential losses by providing a Government guarantee on bonds issued to such contractors. SBA guarantees up to 90 percent for contracts not exceeding \$1.25 million. The SBG program is administered by SBA's Office of Surety Guarantees (OSG).

OBJECTIVE, SCOPE AND METHODOLOGY

SBA's Office of Inspector General (OIG) requested Cotton & Company to conduct a performance audit of Contractors Bonding and Insurance Company (CBIC). The primary objectives were to determine if:

1. Claims and expenses paid by SBA were allowable, allocable, and reasonable.
2. CBIC complied with SBA's and its own policies and procedures in applying for bond guarantees for which SBA paid claims.
3. Fees due SBA were accurately calculated and remitted in a timely manner.

We obtained the universe of ten bonds for which SBA had paid claims during the period October 1, 1995, through April 30, 1998. Our total sample size was 7 bonds (see attachment) with claims (net of recoveries) totaling \$637,966. The sample represents 27 percent of the \$2,350,511 total claim payments (net of recoveries) per SBA's Claim Payment History Reports.

We tested sample bonds for compliance with SBA regulations for underwriting and fees by reviewing underwriting files and CBIC's accounting records. We tested claims incurred under sample bonds through April 30, 1998, by reviewing CBIC's supporting documentation in the claim files and accounting records. We obtained a list of all SBA-guaranteed final bonds from October 1, 1995, through

May 31, 1998, and identified contractors with total bonds exceeding \$1.25 million for contracts with the same obligee and bond issue dates within several months. We then reviewed project descriptions to determine if the bonds were for a single project divided into more than one contract. We also determined if any bonds issued to the sampled contractors were in default status prior to the sampled bond execution dates and if bonds were issued to these contractors after the sampled bonds were placed in default. Finally, we calculated the outstanding fee amount CBIC owed SBA as of April 30, 1998.

In addition to the tests described above, we reviewed powers-of-attorney documents for three bonds identified by OSG to determine if the powers were valid.

We conducted fieldwork during June 1998 at CBIC's offices in Seattle, Washington. The audit was conducted in accordance with *Government Auditing Standards*, 1994 revision, except as described below.

FOLLOW-UP ON PRIOR AUDITS

The scope of our audit did not include following up on findings and recommendations from previous audit reports.

AUDIT RESULTS AND RECOMMENDATIONS

CBIC did not always comply with SBA's policies and procedures for processing claim payments and underwriting bonds. Specifically, CBIC claimed in-house legal fees considered to be CBIC overhead costs, excess loss under one bond, and expenses for a bond that did not have a loss. Also, CBIC issued bonds for contracts constituting "single projects" that aggregated more than \$1.25 million, executed bonds using incorrect powers of attorney, and did not retain a required underwriting document. As a result, we questioned \$140,119 and noted that SBA guaranteed \$2,715,074 on ineligible bonds. In addition, CBIC calculated fees correctly and reconciled its records of fees due SBA to SBA's records on a monthly basis; immaterial differences exist, however, that have not yet been resolved.

We conducted an exit conference with CBIC personnel on June 19, 1998. CBIC personnel generally agreed with factual aspects of the findings and stated that they would review their records to determine if they could locate additional documentation to support some of the findings noted.

Our findings and recommendations are discussed in detail below.

1. CBIC Legal Fees

Before January 1, 1996, CBIC used the [FOIA ex. 6] Law Firm to adjust its bond claims, handle subrogation efforts, and handle CBIC corporate legal matters. The [FOIA ex. 6] Law Firm's owner became the president of CBIC in 1983, and one of its attorneys was CBIC's secretary. In January 1996, [FOIA ex. 6] Law Firm employees (two attorneys, one paralegal, and one clerk) became employees of CBIC. These employees continued to handle CBIC's corporate legal matters and process nationwide bond claims, including defending lawsuits and filing indemnity actions within Washington State. The [FOIA ex. 6] Law Firm maintains an inactive license and has no employees.

CBIC claimed reimbursement from SBA for in-house legal fees totaling \$26,303 since January 1996. We question these loss adjustment expenses in accordance with 13 CFR 115.16, Determination of Surety's Loss, which states:

Loss does not include the following expenses: (1) Any unallocated expense, or any clear mark-up on expenses or any overhead, of the Surety, its attorney, or any other party hired by the Surety or the attorney;...

The regulations do not specifically define overhead. SBA, however, considers costs of all in-house surety activities to be overhead, which is covered by the bond premium collected from the principal.¹ Accordingly, we question all in-house legal costs claimed for reimbursement from January 1, 1996. SBA has not, however, paid CBIC for any of these costs.

CBIC maintains that the regulations do not distinguish between in-house and outside expenses. It considers its billing practices to comply with regulations requiring all expenses to be actually paid and allocable to particular claims through a reasonable method and to exclude markup or general overhead expenses.

We obtained CBIC's December 5, 1997, correspondence to SBA describing its method of billing SBA for legal department fees, and we reviewed CBIC's calculation of the May 1998 billing rate and Calendar Year 1997 Departmental Breakdown of Expenses. We noted the following.

CBIC Rationale: Legal department costs are actually paid.

Cotton & Company Analysis: CBIC's FY 1997 legal department costs include salaries and fringe benefits, as well as 22 other expense items, such as rent, office supplies, travel and entertainment, and insurance. Because we did not audit actual legal department costs, we did not verify that all expenses were actually paid. Fringe benefit costs include retirement, company incentive plans, and manager incentive plans that may not always be funded (or paid) during the period they are expensed and allocated to benefiting departments.

CBIC Rationale: Legal department expenses are specifically allocable to the claim under the SBA bond. Only actual time spent on an SBA claim file is billed to SBA at the hourly rate calculated based on legal department costs divided by total legal department hours. Attorneys bill actual hours worked although at least 8 hours is billed each day even if the attorney does not work the entire 8-hour day.

Cotton & Company Analysis: It is unclear from reviewing sample timesheets if CBIC includes vacation, holiday, and sick time on its timesheet, because these hours are not specifically identified as such. CBIC stated, however, that vacation and sick leave are included in the general corporate billing category. It is also unclear whether CBIC has been recording total hours worked since October 1, 1996. On the May 31, 1998, Calculation of Rates, a note states that the legal department senior vice president will talk to staff about charging all hours. A base that includes vacation, holiday, and sick leave hours is

¹ CBIC collects a premium from the principal to issue the bond and remits to SBA a guarantee fee, a certain percentage of the bond premium.

conservative, because related costs are generally treated as fringe benefits and are allocable to final cost objectives, if fringe benefits are allowable. A base that does not include total hours incurred on all legal department activities is not, however, equitable, because it does not permit an allocation method based on a causal and beneficial relationship.

CBIC Rationale: The monthly billing rate is based on actual costs, and this same rate is charged internally to other CBIC departments, reinsurers, and indemnitors.

Cotton & Company Analysis: CBIC's method of calculating hourly rates differs from the explanation provided in its December 5, 1997, letter. CBIC allocates prior month actual costs adjusted for a to-date variance between actual and allocated costs of previous months. CBIC allocates legal department costs to its property and casualty (P&C) functions using a predetermined hourly rate, which was \$50 until May 1998 when it was raised to \$73.09. CBIC also uses a predetermined hourly rate for allocating costs to its paralegal activities. After determining costs allocated to the P&C and paralegal activities, remaining legal department costs are used to determine an hourly rate for remaining department activities (CBIC matters and contract bonds). This method is not equitable; it does not assure that P&C activities absorb a fair share of department actual costs. This can only be demonstrated if CBIC segregated legal department costs into various homogeneous cost pools and then computed separate hourly rates.

CBIC stated that, beginning January 1, 1999, the P&C claims operation will become a separate department, thus alleviating the need to allocate costs between two operations.

CBIC Rationale: The legal department hourly rate includes no mark up, profit, or non-legal department overhead. Executive, accounting, information technology, and other department costs are not included in the direct costs used to compute hourly rates, even though some of these departments provide services to the legal department. The legal expense allocated to the handling of specific claims is properly considered an allocated expense and is not included in general overhead.

Cotton & Company Analysis: CBIC bases its hourly rates on actual costs either incurred by or allocated to the legal department and does not include a factor for mark-up or profit. Legal department costs include, however, an allocable share of indirect costs typically included in fringe benefit, overhead, and general and administrative cost pools. These are:

- Rent on building and equipment
- Travel and entertainment
- Utilities
- Office supplies
- Insurance expense
- Depreciation and amortization
- Bank fees
- Advertising
- Subscription and dues
- Conventions and shows

Based on the 1997 Departmental Breakdown of Expenses, legal department share of non-payroll and fringe benefit expenses equaled about 3 percent of CBIC's total non-payroll and fringe benefit expenses. Legal department non-payroll and fringe benefit expenses comprised about 20 percent of total legal department costs.

We question total legal department costs of \$26,303 for the reasons discussed above.

Recommendation: We recommend that the Associate Administrator, OSG, obtain an SBA legal counsel decision whether in-house legal costs constitute a reimbursable loss under the regulations and, if so, notify CBIC of the need to develop a billing methodology complying with legal counsel's decision. R61

CBIC Response: CBIC stated that CBIC operates in a manner different from other sureties in that its in-house lawyers allocate their time to each matter and thus a proportionate share of the department's expenses is allocated to each matter. Such expenses are treated as allocated loss adjustment rather than as part of CBIC's general overhead. As the legal department itemizes and documents its expenses, which are specifically allocated to investigation and adjustment of claims, CBIC fails to see why in-house legal fees should be treated differently than if CBIC hired outside services.

The legal department's hourly rates do not include a markup or profit and thus it is cheaper for CBIC to use its in-house legal services than to hire outside firms. Further, the expenses allocated to the legal department are expenses that law firms incur and consider in their hourly rates. CBIC is willing to work with SBA to identify those expenses that should be reimbursed. However, based on current wording of the regulations, SBA cannot treat CBIC's claim for legal expenses any differently than another surety's claim for reimbursement of outside legal expenses.

CBIC stated that except for rent expenses, the direct and indirect expenses of the legal department are actually paid by CBIC. The rent expense allocated among various CBIC departments is not the rent CBIC pays to the owners of the land upon which its building is located but rather the fair rental value of office space in Seattle in 1992.

CBIC stated that it equitably allocates the cost of the legal department to the P&C department in arriving at its predetermined hourly rates, as supported by an analysis performed by the accounting department. It includes the payroll cost of the P&C department plus 40 percent of the legal departments operating expense. While CBIC feels this is a fair and equitable allocation to the P&C operation, in January 1999, the P&C claims operation became a separate department thus alleviating the need to allocate the costs between two operations.

Accountants' Additional Comments: We continue to recommend that OSG obtain a legal counsel decision to determine if in-house legal costs constitute reimbursable loss under the regulations. If the decision is to reimburse CBIC for such costs, OSG and SBA should work together to determine what types of costs should be included in the hourly rates, as suggested by CBIC. In cost reimbursable situations, the cost of rent for company-owned buildings is limited to the constructive cost of ownership, such as depreciation, taxes, insurance, facilities capital cost of money and maintenance, rather than comparable rent for the geographic location.

2. **Excess Claim for Reimbursement** (This finding was deleted from the final audit report)
3. **Legal Fees Not Allocable to a Loss** (This finding was deleted from the final audit report)
4. **Aggregation of Contracts Exceeding Statutory Limits**

On two occasions, CBIC issued separate bonds for two contracts constituting "a single project" and aggregating more than \$1.25 million; the aggregated contracts were with the same principal and obligee, and work was performed in the same general location. The contract project descriptions were:

Dixie-Southern Construction (80% SBA guarantee)		
Bond No. FL2047 Execution Date: 12/28/95 Negotiated	\$1,021,053	To furnish and supply lot carbon steel, rubber lined pipe, and fittings to [FOIA ex. 6] c/o Israel Chemicals Projects, LTD (obligee).
Bond No. FL2051 Execution Date: 12/28/95 Negotiated	\$970,902	To furnish and supply lot carbon steel, rubber lined pipe, and fittings to Rotem Amfert Negev, c/o Israel Chemicals Projects, LTD (obligee).
[FOIA ex. 6] Mechanical Company (80% SBA guarantee)		
Bond No. WB6189 Execution Date: 12/01/95 *	\$688,704	Mechanical work for Academic Training Complex at Fairchild Airforce Base.
Bond No. WB6190 Execution Date: 12/01/95 *	\$713,184	Mechanical work for KC-135 Squadron Operations/AMU Facility at Fairchild Airforce Base.

* We could not determine if these contracts were bid or negotiated.

Title 13 CFR 115.11, Definitions (1995 regulations), states that the contract amount is not to exceed \$1.25 million in face value. The amount of two or more contracts for a single project to be performed in phases are not to be aggregated if the prior bond is released (other than for maintenance or warranty) before the beginning of each succeeding phase. A single project is defined as one represented by two or more contracts of one principal or its affiliates with one obligee or its affiliates for performance at the same locality, irrespective of job title or nature of the work to be performed.

Accordingly, SBA guaranteed ineligible bonds totaling \$2,715,074 (\$3,393,843 x .80 SBA guarantee). As of April 30, 1998, no claims had been paid under the bonds, and CBIC listed the bonds as being closed.

Recommendations: We recommend that the Associate Administrator, OSG:

1. Obtain clarification from legal counsel as to whether CBIC complied with the 1995 regulations in executing the bonds in question, given the facts stated in CBIC's response to the draft audit report. BCI
2. If CBIC is determined to be in noncompliance, notify them that they are not following SBA's regulations and, if the warranty periods for these bonds have not expired, future claims could be in jeopardy. Also, the AA/OSG should request CBIC to implement policies and procedures to ensure bonds are not issued for contracts exceeding \$1.25 million if they constitute a single project. BJD

CBIC Response: CBIC stated that the regulation cited in the audit report does not support the recommendation because it sets forth only when contract amounts will be aggregated on a single project that is phased, but does not address whether the contract amounts will be aggregated in other fact situations. The position advanced by the auditor was subsequently adopted, but was not effective until after the bonds in question were written. CBIC stated that the projects in question were not phased and were completed without claim. In addition, CBIC stated that SBA's SBG specialist approved the bonds for each contractor on the same date. In the event that SBA determines the bonds ineligible, CBIC expects SBA to immediately refund the premium it received for these bonds.

Accountants' Additional Comments: Based on the response, we have revised the recommendation to OSG.

5. Invalid Powers-of-Attorney Issued

CBIC issued invalid powers of attorney for three bonds as follows:

1. **SBG No.** [FOIA ex. 2] (**Bond No. LB0699**): CBIC stated that its agent used a power of attorney for license and permit bonds rather than the proper power of attorney for contract bonds. CBIC stated, however, that the bond was properly approved and authorized.
2. **SBG No.** [FOIA ex. 2] (**Bond No. LB0832**): CBIC stated that its agent used a power of attorney for license and permit bonds rather than the proper power of attorney for contract bonds. The power of attorney certificate noted that Bond No. SA0233 was signed and sealed on March 24, 1997, and included a statement that it was not valid for bonds executed on or after December 7, 1996. CBIC stated that the error was discovered, and a contract power of attorney was issued. We could not determine when the revised power of attorney was issued; it was, however, accompanied by a transmittal letter from the agent dated February 19, 1998.
3. **SBG No.** [FOIA ex. 2] (**Bond No. LB0979**): CBIC stated that the bond number allocated to an agent to issue a bond differed from the number on SBA Form 990, Surety Bond Guarantee Agreement. When the difference was discovered, CBIC issued a rider to the bond to change the number to agree with the SBA Form 990. The original powers of attorney were dated April 30, 1997, and the revised powers were dated May 2, 1997.

Title 13 CFR 115.10, Definitions (1997 regulations), states that execution means signing by a surety representative or agent with the authority and power to bind the surety. The lack of proper issuance of the required powers of attorney affects the quality of CBIC's underwriting and could result in denial of liability for coverage under the bond guarantee.

During fieldwork, CBIC represented that these three bonds were closed without claim. SBA has, however, received claims for reimbursement under each of the bonds as follows:

SBG No.	Total Claim Amount	Date on SBA Form 994(H)
[FOIA ex. 2]	\$61,141	October 31, 1997
[FOIA ex. 2]	\$35,114	October 31, 1997
[FOIA ex. 2]	\$17,561	October 14, 1997

We question the claimed amounts for these bonds totaling \$113,816.

Recommendation: We recommend that the Associate Administrator, OSG, request CBIC to:

1. Provide SBA a written affidavit or other support indicating that [FOIA ex. 6] was indeed an attorney-in-fact for CBIC's agent when the bonds were executed or ratify the powers of attorney for these three bonds.
2. Strengthen its internal controls to ensure that valid powers of attorney are granted before issuing SBA-guaranteed bonds in the future.

CBIC Response: CBIC stated that the bonds in question were executed long after CBIC appointed [FOIA ex. 6] as its agent and [FOIA ex. 6] as its attorney-in-fact. The fact that the wrong power-of-attorney was inadvertently attached to the bond does not negate the fact that CBIC did authorize the agent to execute the bonds or that SBA authorized the bonds to be written and accepted premium for the bonds. CBIC has no choice but to honor its obligations under the bond and SBA statutes, regulations and guarantee agreement do not provide that SBA can void its guarantee because the wrong power-of-attorney is used. Upon request, CBIC can provide an affidavit from the underwriter setting forth that [FOIA ex. 6] and [FOIA ex. 6] were authorized to issue the bonds in question.

Accountants' Additional Comments: We reviewed the appointment certificate attached to CBIC's response to the audit report and noted that [FOIA ex. 6] Insurance was authorized to represent CBIC from May 25, 1995 through October 9, 1999. We also reviewed the September 4, 1996, memorandum provided with CBIC's response, indicating that [FOIA ex. 6] was appointed attorney-in-fact effective September 3, 1996. It was not evident that [FOIA ex. 6] was still authorized in February, March and April when the bonds in question were executed. Accordingly, we revised our recommendation to include obtaining an affidavit from the underwriter, or ratification of the powers of attorney.

6. Underwriting Document Not Provided

CBIC's file retention policy did not comply with SBA requirements. Specifically, CBIC could not locate a required underwriting document for one sampled bond (Sample No. 3). CBIC did not provide Form 1624, Certification Regarding Debarment, Suspension, Ineligibility, and Voluntary Exclusion of Lower Tier Covered Transactions. Title 13 CFR 115.40 (b), Records (1994 regulations), states that relevant records within the meaning of paragraph (a) of this section are to be maintained for the term of the bond, plus any additional time required to settle claims for which the surety may seek recovery from SBA or attempt salvage or other recovery and for an additional 3 years thereafter.

CBIC stated that it did not always keep copies of Form 1624 in the underwriting files, but it submitted all required forms to SBA prior to bond approval. CBIC and its branch offices were able to provide the majority of underwriting documentation sufficient to determine general compliance with SBA's underwriting regulations.

Recommendation: We recommend that the Associate Administrator, OSG, request CBIC to revise its underwriting procedures to ensure that all required documents are obtained and retained in the files for the time period required by SBA regulations. p2

CBIC Response: CBIC does not dispute the auditors' finding and it is now CBIC's policy to retain all required documents submitted to SBA in its files.

Accountants' Additional Comments: None.

MANAGEMENT CONTROLS

The scope of our audit did not include assessing management controls, and thus we did not identify or test such controls.

SBA MANAGEMENT'S RESPONSE

The Associate Administrator, OSG, stated that he reviewed the draft audit report and agreed that the recommendations have merit.

COTTON & COMPANY, LLP

By: [FOIA ex. 6]
Catherine L. Nocera, CPA

SAMPLE BONDS

Sample No.	Surety Bond Guarantee No.	CBIC Bond No.	Contractor Name	Bond Approval Date	Bond Default Date
1	[FOIA ex. 2]	HI0025	[FOIA ex. 6]	08/16/89	04/10/90
2	[FOIA ex. 2]	970372	[FOIA ex. 6]	05/12/89	05/23/90
3	[FOIA ex. 2]	WB0774	Choctaw Construction Co.	08/29/94	04/21/95
4	[FOIA ex. 2]	001954	[FOIA ex. 6]	09/08/82	06/83
5	[FOIA ex. 2]	WA5565	Pacific West Industries, Inc.	08/12/92	06/01/93
6	[FOIA ex. 2]	WB7518	[FOIA ex. 6]	02/16/96	12/16/96
7	[FOIA ex. 2]	LB0732	[FOIA ex. 6]	02/28/97	04/28/97

APPENDIX

CONTRACTORS BONDING AND INSURANCE COMPANY



Kevin L. Lybeck
Senior Vice President

RECEIVED

FEB 25 1 22 PM '99

OFFICE OF SURETY
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February 9, 1999

VIA FEDERAL EXPRESS

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

Re: SBA Audit

Dear Mr. Moffitt:

This letter is written in response to the draft audit report prepared by the Office of Inspector General. I will address each issue in the order set forth in the report.

CBIC's In-House Legal Fees. The auditor questions CBIC entitlement to be reimbursed for its in-house legal fees, and has recommended that you obtain a legal opinion from SBA legal counsel regarding whether in-house legal costs are reimbursable under the regulations. I will address each of the issues addressed by the auditor in the order in which they are raised.

Are CBIC's In-House Legal Expense Considered a Reimbursable Loss? The auditor questions whether CBIC in-house legal fees are a reimbursable loss as the SBA considers costs of in-house legal surety activities to be overhead. The auditor bases her position on 13 CFR 115.16, which provides, in pertinent part, as follows:

"Loss does not include the following expenses: (1) unallocated expense, or any clear mark-up on expenses or any overhead, of the Surety, its attorney, or any other party hired by the Surety or its attorney"

CBIC operates in a manner different from other sureties in that its in-house lawyers allocate their time to each matter they handle. As a result, a proportionate share of the legal department's expenses is allocated to each matter handled by a lawyer. To the extent that legal department expenses are allocated to a specific claim file, those expenses are not treated as part of CBIC's general overhead. Rather, these expenses are treated as allocated loss adjustment expense.

The auditor acknowledges that the regulations do not define overhead, but indicated that the SBA considers cost of all in-house surety activities to be overhead. Please note that 13 CFR 115.16 treats the expenses of sureties, outside attorneys, and other parties hired by the surety or attorney equally. Therefore, if the SBA contends that CBIC cannot include certain allocated overhead costs in its calculation of the in-house attorneys' hourly rate, the regulations also require the SBA to apply the

same rule to outside lawyers and consultants. Does the SBA think that outside attorneys and consultants do not include all overhead costs (as well as profit) in determining their hourly rates?

13 CFR 115.16(e) specifically provides, among other things, that CBIC is entitled to be reimbursed for the costs of "investigation" and "adjustment" of claims, provided the costs are itemized and documented. As the legal department itemizes and documents its expenses, we fail to see why CBIC's in-house legal fees (which are specifically allocated to "investigation" and "adjustment" of SBA claims files) should be treated any differently than if CBIC hired outside law firms or adjustment firms to perform those services.

As the legal department's hourly rates do not include a markup or profit, it is cheaper for CBIC (and the SBA) to have CBIC's in-house lawyers provide legal services (as opposed to hiring outside firms to provide those services). Furthermore, the expenses allocated to the legal department are expenses that law firms incur and take into consideration (along with profit) in setting their hourly rates. CBIC is willing to work with the SBA to identify those expenses for which CBIC will be reimbursed. However, based on the current wording of the regulation, the SBA cannot treat CBIC's claim to be reimbursed for in-house legal expenses any differently than it would treat a surety's claim to be reimbursed for legal services provided by an outside law firm.

Are CBIC's In-House Legal Expenses Actually Paid? The expenses of the legal department are comprised of direct expenses (i.e., salaries, travel expenses, etc.) and indirect expenses (utilities, insurance expense, etc.). The direct expenses and all indirect expense (other than rent) are actually paid by CBIC. The rental expense allocated among the various departments is not the rent CBIC pays to the owners of the land upon which its building is located, but is based on what the fair rental value of office space in Seattle was in 1992. Please note that CBIC has not increased the amount charged for rent despite the fact that the rental value of office space in Seattle has increased since 1992. CBIC is not seeking to make a profit by having its in-house lawyers provide legal services. Rather, CBIC is merely trying to save itself (and the SBA) money as it is cheaper to have in-house attorneys provide legal services than outside firms.

Calculation of Hourly Rates. CBIC's in-house hourly rate is determined by taking the expense of the department and dividing it by the number of hours billed by the lawyers. Based upon a random review of each lawyer's timesheets, we have determined that each lawyer has billed at least 8 hours a day since January 1, 1996 (the date the attorneys became employees of CBIC).

The auditor notes that for accounting purposes the expense of CBIC's P&C claims operation is included in the legal department. The auditor also notes that CBIC allocated the legal department's costs to the P&C department using a predetermined hourly rate of \$50.00.¹ Thereafter, the auditor opines that CBIC's method of allocating costs is not equitable because it does not insure that the P&C department will absorb a fair share of the actual costs of the legal department.

¹ The auditor notes (based on a footnote in my December 8th letter) that the predetermined hourly rate for P&C claim personal increased from \$50.00 per hour to \$73.09 per hour in May 1998. Please be advised that the hourly rate was increased just during the month of May 1998 in order to allocate to the P&C operation the cost of moving [FOIA ex. 6] (who was hired as the director of P&C claims) from California to Washington.

CBIC believes that it has equitably allocated cost of the legal department to the P&C department in arriving at the predetermined hourly rates. The hourly rate for the P&C claims was arrived at through an analysis performed by CBIC's accounting department. The accounting department determined the hourly rate based the payroll costs of P&C claims personnel, plus 40% of the legal department's operating expenses, arriving at the \$50.00 per hour rate.² This hourly rate is then multiplied by the total hours of the P&C claims personal to arrive at P&C's share of the expense of the legal department. We feel this is a conservative and equitable allocation of the operation expenses to the P&C operation. However, as of January 1, 1999, the P&C claims operation became a separate department thereby alleviating the need to allocate the cost between the two operations.

Excess Claim for Reimbursement (bond no. WB0774). Based upon the auditor's review of CBIC's records, she determined that CBIC submitted a reimbursement claim that exceeds the amount of loss CBIC's records indicate it sustained by \$2,542. CBIC disputes that its claim is excessive for the reasons set forth below.

The only bond that CBIC provided to Choctaw Construction that went into claim is bond no. WB0774. However, due to a billing error a portion of The [FOIA ex. 6] Law Firm's bill was mistakenly allocated to another SBA bond written for Choctaw Construction (bond no. WA6606; SBG no.

[FOIA ex. 2] This mistake was uncovered and a 994H was submitted including the costs erroneously billed to bond no. WA6606. As a result of an oversight, CBIC internal records were not corrected. Attached as Exhibit "A" are The [FOIA ex. 6] Law Firm's billings, and a print out indicating these legal bills were erroneously applied to bond no. WA6606. As the legal fees were incurred as a result of claims made against bond no. WB0774, CBIC respectfully disputes the auditor's recommendation that CBIC be required to reimburse the SBA.

Legal Fees Not Allocable to a Loss (bond no. WB0939). The auditor recommends that CBIC be required to reimburse the SBA for \$126 in costs incurred on the above-reference bond because CBIC did not sustain a loss under the payment or performance bonds. The costs questioned represent the SBA's portion of a \$110.00 filing fee paid by CBIC to bring suit against the [FOIA ex. 6] (the suit where we obtained a judgment against them) for losses sustained on bond nos. WB1347 and WB1527, and approximately \$48.00 in legal fees paid by CBIC to The [FOIA ex. 6] Law Firm, P.S. Unfortunately, a billing error occurred and these expenses were applied to bond no. WB0939 (despite the fact that we did not sustain a loss on this bond). Nonetheless, these expenses were incurred in an indemnity action brought against CBIC indemnitors seeking to recover losses sustained on bond nos. WB1347 (SBG# [FOIA ex. 2] and WB1527 (SBG # [FOIA ex. 2] CBIC is correcting its records to properly reflect the application of these costs to WB1347 and will submit a new 994H. Based on these facts, the SBA is clearly obligated to reimburse CBIC for the above-referenced expenses.

Aggregation of Contracts Exceeding Statutory Limits. The auditor has recommended that the SBA deny liability on bond nos: FL2047, FL2051, WB6189 and WB6190 if any claims are received in the future. The basis for her recommendation is that "CBIC issued separate bonds for two contracts constituting 'a single project' and aggregating more than \$1.25 million; the aggregated

² The 40% figure was arrived at based on the number of employees in each department.

contracts were with the same principal and obligee, and work was performed in the same general location."

In making her recommendation, the auditor relied on Title 12 CFR 115.11, Definitions (1995 Regulations). This section provides, in pertinent part, as follows:

The contract amount shall not exceed \$1,250,000 in face value. The amount of two or more contracts for a single project, to be performed in phases, shall not be aggregated if the prior bond is released (other than for maintenance or warranty—see definition of "contract" in this section) before the beginning of each succeeding phase. A "single project" means one represented by two or more contracts of one principal or its affiliates with one obligee or its affiliates for performance at the same locality, irrespective of job title or nature of the work to be performed.

The regulation, however, does not support the auditor's recommendation. The regulation sets forth only when contract amounts will be aggregated on a "single project" that is phased, but does not address whether the contract amounts will aggregate in any other fact situation. The position being advanced by the auditor was subsequently adopted on January 31, 1996 (13 CFR 115.12(e)(2)). However, these revisions were not effective until after the bonds in question were written.

The projects in question were not phased. [FOIA ex. 6] entered into two separate contracts with Oswood Construction. Oswood in turn had two separate contracts with Fairchild Air Force Base (contract nos. DACA67-95-C-0104 and DACA67-95-C-0106) to perform construction work on two separate buildings. While the term "phased project" is not defined in the SBA's regulations, it is difficult to imagine that two separate contracts for separate buildings on an Air Force Base could be considered a phased project. Both projects have been completed without claim.

Dixie-Southern's contracts were not phased as well. Acid Pipe Technology (a material distributor) issued two purchase orders to Dixie Southern. Under these purchase orders, Dixie Southern was to fabricate materials that Acid Pipe Technology was under contract (two purchase orders) to supply to [FOIA ex. 6] (a private company in Israel). It is my understanding that the materials were used on two different plants (a sulfuric plant and a phosphoric plant) and the work was performed concurrently on the projects. Dixie-Southern has delivered the materials and no claim has been made on the bonds.

In making your decision, please note that the applicable SBG specialist approved the bonds for each contractor on the same date, and all of the bonded obligations have been completed without claim. In the event that the SBA determines that the bonds in question are ineligible for the SBA guarantee, CBIC expects the SBA to immediately refund the premium it received for these bonds.

Invalid Powers-of-Attorney. The auditor questions the SBA's obligation to indemnify CBIC for losses sustained on the following bonds: LB0699, LB0832, and LB0979. The auditor questions the SBA's indemnity obligation based upon her belief that the agent was not authorized to issue the bonds because they had "invalid powers of attorney" attached to them.

The fact that the wrong power of attorney was attached to the above-referenced bonds does not mean that CBIC's agent was not authorized to execute the bonds. Rather, powers-of-attorney are attached to bonds to provide proof to obligees that the person signing a bond on behalf of the surety has the authority to bind the surety.

In this case, CBIC received the bond submissions from [FOIA ex. 6] submitted them to the SBA to obtain guarantees, obtained the guarantees, and authorized [FOIA ex. 6] to execute the bonds as CBIC's agent (and affix CBIC's seal thereon). [FOIA ex. 6] works for [FOIA ex. 6] Insurance. CBIC appointed [FOIA ex. 6] as its agent on May 25, 1995, as is evidenced by the appointment certificate attached as Exhibit "B." Furthermore, as is evidenced by the September 4, 1996 memo attached as Exhibit "C," CBIC has authorized [FOIA ex. 6] to sign bonds as CBIC's attorney-in-fact. Please note that the bonds in question were executed on February 3, 1997, March 24, 1997 and April 30, 1997, respectively. Accordingly, the bonds were executed long after CBIC appointed [FOIA ex. 6] as its agent and [FOIA ex. 6] as its attorney-in-fact.

In Washington, an agent ([FOIA ex. 6] Insurance) is not required to have a written instrument (i.e., a power of attorney) before it can bind its principal (CBIC) on a contract (i.e., a bond). Rather, an agency relationship can be created orally. *Sharpe Signs Co. v. Parrish*, 33 Wn.2d 883 (1949). Furthermore, Washington law provides that an insurance agent's authority may be extended as far as the authority to execute insurance policies.³ RCW 48.17.010 provides:

"Agent" means any person appointed by an insurer to solicit applications for insurance on its behalf. If authorized to do so, an agent may effectuate insurance contracts. An agent may collect premiums on insurance so applied for or effectuated.

Accordingly, the fact that the wrong power-of-attorney was inadvertently attached to the bonds does not negate the fact that CBIC **did authorize** the agent to execute these bonds,⁴ or that the SBA authorized the bonds to be written and accepted the premium for the bonds. Accordingly, when CBIC received claims on these bonds, it had no choice but to honor its obligations under the bonds.

Likewise, the SBA is obligated to honor its guarantees. We have reviewed the SBA statutes (13 U.S.C. § 694a, et. seq.), regulations (13 CFR 115 et. seq.), and guarantee (Form 990), and they do not provide that the SBA can void its guarantees because the wrong power of attorney is attached to bonds.

The auditor reports that CBIC ([FOIA ex. 6]) represented to Cotton & Company ([FOIA ex. 6]) that these bonds were closed without claim. As I previously informed the auditor, [FOIA ex. 6] has no recollection of telling [FOIA ex. 6] that these bonds were closed without a claim. I also advised her that I suspected that this misunderstanding came about as a result of a miscommunication as CBIC had nothing to gain by misleading them (particularly in light of the fact

³ Washington law provides that a surety bond is insurance. See, RCW 48.11.80.

⁴ Upon request, CBIC can provide an affidavit from its underwriter setting forth that [FOIA ex. 6] and [FOIA ex. 6] were authorized to issue the bonds in question.

Letter to Mr. Moffitt

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that CBIC submitted to the SBA a claim for reimbursement for losses sustained on these bonds). Thus, we do not understand why this issue continues to be raised, unless the auditor is accusing CBIC of attempting to intentionally mislead the SBA. If so, CBIC denies this allegation.

Underwriting Documents Not Provided. CBIC does not dispute the auditor's finding and it is now CBIC's policy to retain all required documents submitted to the SBA in its files.

Attached as Exhibit "D" is a spreadsheet setting forth CBIC's outstanding reimbursement requests. Please note that CBIC has reimbursement requests total \$563,929.53, and that the auditor has questioned only \$142,787 of that amount. CBIC feels that entire amount requested is past due and requests an explanation regarding why the undisputed amount has not been paid.

If you have any questions or need any additional information, please do not hesitate to call.

Very truly yours,

CONTRACTORS BONDING
AND INSURANCE COMPANY

[FOIA ex. 6]

Kevin L. Lybeck

Encl: Exhibits A, B, C and D.
cc: Steven A. Gaines
Bob Ogle
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