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

AUDIT REPORT
Issue Date: August 21, 2000
Number: 0-23

To: Robert J. Moffitt
Associate Administrator, Office of Surety Guarantees

From: Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of American Reliable Insurance Company

Attached is a copy of the audit report on American Reliable Insurance Company (American Reliable) issued by Cotton & Company, LLP. The report discusses the following problems: (1) required underwriting documentation was not maintained, (2) unallowable losses and expenses were claimed, (3) expenses were not allocable to the bond, (4) an expense was not supported by a cancelled check, (5) SBA's guarantee percentage was not adjusted when the final contract exceeded the statutory limit, and (6) all sources of recovery were not pursued.

You may release this report to the duly authorized representative of American Reliable. The findings included in this report are based on the auditors' conclusions. 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 decision for each recommendation on the attached forms 1824, Recommended Action Sheet, within 80 days. If you disagree with the recommendations, please provide your reasons in writing.

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. Should you or your staff have any questions, please contact Robert Hultberg, Business Development Programs Group at (202)205-7204.

Attachments

INDEPENDENT ACCOUNTANT'S REPORT ON THE

PERFORMANCE AUDIT OF

AMERICAN BANKERS/AMERICAN RELIABLE INSURANCE COMPANIES

Performed by:

Cotton & Company LLP
Certified Public Accountants
333 North Fairfax Street, Suite 401
Alexandria, Virginia 22314

COTTON & COMPANY LLP

CERTIFIED PUBLIC ACCOUNTANTS

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November 13, 1998

U.S. Small Business Administration
Office of Inspector General

BACKGROUND

The Small Business Administration's (SBA) Surety Bond Guarantee Program (SBG), authorized by the Small Business Investment Act of 1958, as amended, 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 the contractors. SBA guarantees up to 90 percent for contracts not exceeding $1.25 million for a Prior Approval Surety. 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 that Cotton & Company LLP conduct a performance audit of American Bankers/American Reliable Insurance Companies (American Reliable). The primary objectives were to determine if:

1. American Reliable 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.

3. Fees due SBA were accurately calculated and remitted in a timely manner.

We obtained the Claim Payment History report from SBA's OSG, which lists all claim payments made to and recoveries received from American Reliable from inception in the surety bond program through September 30, 1998. This report showed 48 defaulted bonds with claim payments. We judgmentally selected eight bonds to test claims and underwriting procedures based on the largest claim amounts. Total claim payments (net of recoveries) in the sample were $3,205,286. This represents 61 percent of the $5,289,214 total claim payments (net of recoveries) per SBA's Claim Payment History Report. Sample bonds are listed in the attachment.

We tested sample bonds for compliance with SBA regulations for underwriting and fees by reviewing underwriting files and American Reliable's accounting records. We tested all claims incurred under the defaulted sample bonds through September 30, 1998, by reviewing American Reliable's supporting documentation in the claim files and accounting records. We obtained a list of all SBA-guaranteed final bonds from American Reliable and identified contractors with total bonds exceeding

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$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 bonds were issued to sampled contractors that had defaulted on bonds prior to bond execution dates.

We conducted fieldwork in October and November 1998 at American Reliable's offices in Scottsdale, Arizona. 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

American Reliable did not comply with SBA's policies and procedures for underwriting bonds. Specifically, American Reliable did not maintain all required underwriting documents. American Reliable also claimed unallowable losses and expenses, including those not covered by the bonded contract, expenses not allocable to the bond, and an expense not supported by a canceled check. In addition, American Reliable did not adjust the SBA guarantee percentage when final contract exceeded the $1.25 million statutory limit, or pursue all sources of recovery. As a result, we questioned $887,954.

We conducted an exit conference with American Reliable personnel on November 13, 1998, to discuss preliminary findings and recommendations. American Reliable personnel stated that they would attempt to locate additional documentation and canceled checks to support some of the findings noted.

Our findings and recommendations are discussed in detail below.

Incomplete Underwriting Documentation Provided

American Reliable did not obtain complete underwriting documents for all sample bonds tested. Specifically, American Reliable did not maintain completed SBA forms in its files that are required when underwriting SBA bonds for seven sample bonds. In addition, for one bond, American Reliable did not provide the underwriting file (Sample No. 5).

Title 13, *Code of Federal Regulations* (CFR) 115.40 (1994, 1995), and Title 13, CFR 115.21 (1996), require retention of all aforementioned records. Accordingly, American Reliable was not in compliance with record retention requirements.

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees, advise American Reliable to comply with record retention requirements for all remaining SBA bonds in the future.

***American Reliable Response*:** American Reliable stated that it noted the finding and recommendation for future underwriting compliance.

***Cotton & Company Response*:** None.

[FOIA EX. 4]

American Reliable issued performance and payment bonds to [FOIA Ex.4] the contract amount. A consultant's report indicated that the contract was about 85 percent complete when [EX. 4] defaulted. American Reliable paid [Ex. 4] of losses and expenses (net of recoveries) under these bonds. We questioned SBA's 80-percent guaranteed portion of [FOIA EX. 4] for the reasons discussed below.

After [EX. 4] defaulted on the contract, American Reliable entered into a takeover agreement on [EX. 4] under the terms of its performance bond. The takeover agreement assigned a completion contractor to complete the original bonded contract plus additional work totaling [EX. 4]. This additional work was not incorporated into the bonded contract by approved change orders. Instead, it was handled by a separate agreement between the obligee and the principal [EX. 4] and a promissory note [EX. 4] to pay [EX. 4] monthly, until the full sum of the agreement was paid. Under this arrangement, [EX. 4] essentially financed the additional work; neither American Reliable nor SBA approved the separate agreement and promissory note. By including the additional work in the takeover agreement, American Reliable implicitly agreed to a material alteration in the bond, which was not approved by SBA.

Title 13, CFR 115.13, Defenses of SBA, states that SBA is to be relieved of all liability under the surety bond guarantee if the surety agrees to or concedes to any material alteration in the terms, conditions, or provisions of the bonds without SBA's prior written approval. A material alteration increases the bond liability by 25 percent or $50,000, whichever is less.

Additionally, CFR 115.16(c) (1996) states that loss under a performance bond is, at the surety's option, the sum necessary to meet the cost of fulfilling the terms of a bonded contract or the penal sum of the bond. CFR 115.16 (e)(1) states that losses are amounts actually paid by the surety, which are specifically allocable to the investigation, adjustment, negotiation, compromise, settlement of, or resistance to a claim for loss resulting from breach of the terms of the bonded contract, if these amounts are itemized, documented, and attributable solely to the loss under the guaranteed bond.

We questioned SBA's guaranteed portion of all claims under the bond, or [EX. 4]. As of September 30, 1998, American Reliable was still seeking recovery from the obligee for remaining contract funds and all funds covering additional work.

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees, advise American Reliable to reimburse [EX. 4] of questioned costs to SBA.

***American Reliable Response*:** American Reliable provided the following in response to the issues stated above:

- The takeover agreement for the original contract and additional work represented only claims under the performance bond, and not the payment bond. Therefore, only claims under the performance bond should be questioned. American Reliable later stated, however, that SBA should guarantee the total loss under the Code for Minimization of Loss.

- American Reliable included the additional work in the takeover agreement to minimize the risk of loss. It was more cost effective to include the additional unbonded work as an enhancement to the takeover contractor and the obligee to obtain a more competitive

price from the takeover contractor. The inclusion of additional items beyond the strict interpretation of the scope of the original bonded contract was beneficial in negotiations with the obligee.

- American Reliable stated that, because of the sequence of remaining work, the bonded work could not have been completed without prior or concurrent completion of the unbonded work. Therefore, it would not have been cost effective to complete obligations under the bond without completing the unbonded work. Additional costs incurred in completing the unbonded work more than offset the cost of damages that would have accrued if the bonded work was not completed in a timely manner. The above actions were taken to minimize the risk of loss.

***Cotton & Company Response*:** We respond to each issue as follows:

- American Reliable did not have SBA prior approval to include the additional work in the takeover agreement. Therefore, American Reliable implicitly agreed to a material alteration to the bond, and total liability is denied. The argument of payment versus performance bond coverage is irrelevant. We continue to recommend recovery of questioned costs of [EX. 4].

- The surety's obligation to minimize risk clearly required the surety to obtain SBA approval prior to signing the takeover agreement. Title 13, CFR 115.13, states that SBA is relieved of all liability under the surety bond guarantee, if the surety agrees to any material alteration in the terms, conditions, or provisions of the bond without SBA's prior written approval.

- The unbonded work was the sole responsibility of agreements between the principal and the obligee. Accordingly, it was the obligee's responsibility to complete the unbonded work. The issues concerning damages for time delays or the cost effectiveness of combining the obligations are irrelevant.

[FOIA Ex. 4]

American Reliable issued performance and payment bonds to [FOIA EX. 4] the contract amount. The obligee declared [FOIA EX. 4] in default of its contract on [FOIA EX. 4]. American Reliable paid [FOIA EX. 4] of losses and expenses (net of recoveries) under these bonds.

a. In its response to the draft report, American Reliable provided a canceled check to support a [FOIA EX. 4] payment to [FOIA EX. 4], a claimant under the bond. Accordingly, we deleted the finding and recommendation.

b. American Reliable improperly included on its Form 994H a [FOIA EX. 4] loan to [FOIA EX. 4] and a [Ex. 4] payment to a construction consultant, which were both allocable to a different bond [FOIA EX. 4]. The loan was apparently made to avoid an imminent breach of the other contract, although American Reliable classified it as a performance bond loss on its Form 994H. American Reliable received a [FOIA EX. 4] recovery, which offset the loan, on [FOIA EX. 4], and also included this on the Form 994H for the sample bond.

Title 13, CFR 115.11, Definitions, states that loss adjustment expense must be specifically allocable to the investigation, adjustment, negotiation, compromise, or settlement of a given claim for loss. We did not question costs related to this misallocation, because both bonds were SBA guaranteed and in default status.

***American Reliable Response*:** American Reliable responded as follows to the two findings noted above:

a. American Reliable provided a copy of the canceled check to support the questioned claims of [FOIA EX. 4].

b. American Reliable did not respond to the finding regarding misallocation of payments to another bond.

***Cotton & Company Response*:** We respond to each issue as follows:

a. As stated above, this finding was resolved. Accordingly, we deleted the finding from our final report.

b. None.

[FOIA EX. 4]

American Reliable issued performance and payment bonds [FOIA EX. 4], on [FOIA EX. 4] for [FOIA EX. 4], the contract amount. The obligee issued [FOIA EX. 4] a default notification on [FOIA EX. 4]. American Reliable paid [FOIA EX. 4] of losses and expenses (net of recoveries) under these bonds.

In its response to the draft report, American Reliable provided canceled checks to support 8 payments under the bonds totaling [FOIA EX. 4]. Accordingly, we deleted the finding and recommendation.

***American Reliable Response*:** American Reliable provided copies of canceled checks to support questioned claims of [FOIA EX. 4].

***Cotton & Company Response*:** As stated above, this finding was resolved. Accordingly, we deleted the finding from our final report.

[FOIA EX. 4]

American Reliable issued performance and payment bonds to [FOIA EX. 4], on [FOIA EX. 4], [FOIA EX. 4], the contract amount. The obligee issued a notice of termination to [FOIA EX. 4]. American Reliable paid [FOIA EX. 4] of losses and expenses (net of recoveries) under these bonds.

In its response to the draft report, American Reliable provided canceled checks to support 15 payments under the bonds totaling [FOIA EX. 4]. Accordingly, we deleted the finding and recommendation.

***American Reliable Response*:** American Reliable provided copies of canceled checks to support questioned claims of [FOIA EX. 4].

***Cotton & Company Response*:** As stated above, this finding was resolved. Accordingly, we deleted the finding from our final report.

[FOIA EX. 4]

American Reliable issued performance and payment bonds to [FOIA EX. 4] on [FOIA EX. 4], the contract amount. A letter from the obligee stated that approximately 12 percent of required work had been completed through [FOIA EX. 4]; the contractor failed to show up at the project site a short time later. American Reliable paid [FOIA EX. 4] of losses and expenses (there were no recoveries) under these bonds.

In its response to the draft report, American Reliable provided canceled checks to support 28 payments under the bonds totaling [FOIA EX. 4]. Accordingly, we deleted the finding and recommendation.

***American Reliable Response*:** American Reliable provided copies of canceled checks to support questioned claims of [FOIA EX. 4].

***Cotton & Company Response*:** As stated above, this finding was resolved. Accordingly, we deleted the finding from our final report.

[FOIA EX. 4]

American Reliable issued performance and payment bonds to [FOIA EX. 4] for [FOIA EX. 4] the contract amount. The obligee declared [FOIA EX. 4] in default of its contract on [FOIA EX. 4]. American Reliable paid [FOIA EX. 4] of losses and expenses (net of recoveries) under these bonds. We questioned SBA's 90-percent guaranteed portion of [FOIA EX. 4], for the reason discussed below.

American Reliable did not provide a canceled check to support one payment under the bonds totaling [FOIA EX. 4]. A check was issued on [FOIA EX. 4], but has not yet been cashed. Title 13, CFR 115.11, Definitions, defines loss adjustment expense as amounts actually paid.

American Reliable provided canceled checks for 10 payments under the bond in its response to the draft report. The finding and recommendation were revised accordingly.

Recommendations: We recommend that the Associate Administrator, Office of Surety Guarantees, advise American Reliable to reimburse [FOIA EX. 4] of questioned costs to SBA.

***American Reliable Response*:** American Reliable provided copies of canceled checks to support 10 of the 11 items questioned. American Reliable did issue the one remaining check, but it was never cashed by the payee and is still outstanding.

***Cotton & Company Response*:** American Reliable did provide conclusive evidence that questioned claims were actually paid for 10 of the 11 items questioned. The remaining check for [FOIA EX. 4] is still considered unresolved, and the finding will remain for this item.

[FOIA EX. 4]

American Reliable issued performance and payment bonds to [FOIA EX. 4], on [FOIA EX. 4], respectively. The obligee declared
[FOIA EX. 4] in default of its contract on [FOIA EX. 4]. American Reliable paid [FOIA EX. 4] of losses and expenses (net of recoveries) under these bonds. We questioned [FOIA EX. 4] and American Reliable's compliance with SBA regulations for the reasons discussed below.

a. American Reliable paid claims under a takeover agreement that incorporated [FOIA EX. 4] of approved change orders into the original [FOIA EX. 4] contract. The change orders were issued between [FOIA EX. 4], prior to the default date. Thus, the final contract amount of [FOIA EX. 4] exceeded the $1,250,000 statutory contract limit. Title 13, CFR 115.31(d), Contract Increases to

Over $1,250,000, states that, if the contract increases above the $1,250,000 statutory limit after bond execution, SBA's share of the loss should be limited as follows:

$1,250,000 ÷ [FOIA EX. 4]

American Reliable did not limit its guarantee percentage to 86.2 percent of losses and expenses paid. Accordingly, its claims for reimbursement included [FOIA EX. 4] of unallowable amounts calculated as follows:

[FOIA EX. 4] × 90%	$[FOIA EX. 4]
[FOIA EX. 4] × 86.2%	[FOIA EX. 4]
	$ [FOIA EX. 4]

b. American Reliable provided canceled checks to support 7 payments under the bonds totaling [FOIA EX. 4] with its response to the draft report. Accordingly, we deleted this finding and recommendation.

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees, advise American Reliable to reimburse [FOIA EX. 4] of questioned costs to SBA.

***American Reliable Response*:** American Reliable responded to these two findings as follows:

a. American Reliable disagreed with the recommendations in the audit report based on its interpretation that the payment bond did not exceed SBA statutory limits. Based on its interpretation, applicable bond losses under the payment and performance bonds would result in [FOIA EX. 4] reimbursable to SBA from the surety.

b. American Reliable provided copies of canceled checks to support questioned claims of [FOIA EX. 4].

***Cotton & Company Response*:** We respond to each issue as follows:

a. American Reliable agreed in principal that contract increases are subject to statutory limits requiring an adjustment of SBA's share of the loss, but continued to assert that payment and performance bonds may be separated to calculate applicable statutory limits. Title 13, CFR 115.31(d), states that, if a contract increases above the $1,250,000 statutory limit after bond execution, SBA's share of the loss shall be limited by the applicable formula. The finding remains, and we continue to recommend recovery of questioned costs of [FOIA EX. 4].

b. As stated above, this finding was resolved. Accordingly, we deleted the finding from our final report.

[FOIA EX. 4]

American Reliable issued performance and payment bonds to [FOIA EX. 4] the contract amount. The obligee issued a notice of termination to [FOIA EX. 4]. American Reliable paid [FOIA EX. 4] of losses and expenses (net of recoveries) under these bonds.

In its response to the draft report, American Reliable provided canceled checks to support 7 payments under the bonds totaling [FOIA EX. 4]. Accordingly, we deleted the finding and recommendation.

***American Reliable Response*:** American Reliable provided copies of canceled checks to support questioned claims of [FOIA EX. 4].

***Cotton & Company Response*:** As stated above, this finding was resolved. Accordingly, we deleted the finding from our final report.

OTHER MATTERS NOTED

We noted the following matters regarding bonds that were not in our sample, which we believe should be reviewed further by either SBA's OIG or OSG.

[FOIA EX. 4]

During our review of the claim file for [FOIA EX. 4] we noted correspondence relating to another bond [FOIA EX. 4] stating that it was issued by an agent who did not have valid powers of attorney in [FOIA EX. 4], when the bond was executed. Payment and performance bonds were issued for [FOIA EX. 4] each, the contract amount. We reviewed a [FOIA EX. 4], letter from American Reliable to its underwriters questioning the bond validity, and stating that American Reliable expected to be held harmless for any losses or costs associated with a claim on these bonds. Title 13, CFR 115.10, Definitions, states that execution is defined as signing by a representative or agent with the authority and power to bind the surety. Accordingly, we concluded that this bond is ineligible for SBA's guarantee.

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees, notify American Reliable that it considers this bond ineligible for SBA's guarantee and that it will deny liability on any claims submitted by American Reliable.

***American Reliable Response*:** American Reliable did not comment on this audit finding.

***Cotton & Company Response*:** The audit finding will remain as stated.

[FOIA EX. 4]

Before beginning our audit, OSG asked us to review this bond to determine the disposition of a [FOIA EX. 4] certificate of deposit that had been taken as collateral when the bond was executed. We reviewed the underwriting and claim files and held discussions with American Reliable representatives.

SBA Form 994B, Surety Bond Guarantee Underwriting Review, states that the surety required additional security in the form of a [FOIA EX. 4] certificate of deposit. American Reliable was not aware of the collateral when it processed claims under the bond and, therefore, did not pursue its right to liquidate the

collateral as part of its recovery efforts. It stated in correspondence to SBA that the agent had stated that the collateral was held on another bond and was released when the project was completed; American Reliable could provide no evidence to support the agent's statement. In a [FOIA EX. 4], letter to SBA, American Reliable requested that SBA process claims under [FOIA EX. 4], less the [FOIA EX. 4] representing the collateral.

The collateral was not netted against claims submitted on the SBA Form 994H. During our exit discussions, an American Reliable representative stated that the company no longer had a relationship with the underwriters of this bond and were unable to obtain documentation to support the existence of the collateral. The representative agreed that American Reliable might have to absorb the loss related to this collateral.

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees, notify American Reliable to reimburse SBA [FOIA EX. 4], which is its guaranteed portion of the collateral ([FOIA EX. 4] × 80%) from present and future claims submitted for reimbursement under this bond. American Reliable should reimburse SBA [FOIA EX. 4] for claims paid by SBA under [FOIA EX. 4]. In addition, SBA will offset future claim reimbursements under this bond by [FOIA EX. 4], the remaining amount of SBA's guaranteed portion of the collateral.

***American Reliable Response*:** American Reliable stated that it will reimburse SBA [FOIA EX. 4] and offset the remaining [FOIA EX. 4] of claims incurred on this bond.

***Cotton & Company*:** 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, Office of Surety Guarantees, stated he had reviewed the draft audit report. He noted that the initial report had 11 findings of which five have been resolved and no recommendations were made. He agrees with the remaining auditor's recommendations.

COTTON & COMPANY LLP

By: Catherine L. Nocera

Catherine L. Nocera, CPA

Attachment

SAMPLE BONDS

Sample No.	Surety Bond Guarantee No.	American Reliable Bond No.	Contractor Name	Bond Approval Date	Bond Default Date
1	[FOIA EX. 4]				
2					
3					
4					
5					
6					
7					
8					

APPENDIX A

AMERICAN BANKERS/AMERICAN RELIABLE INSURANCE COMPANIES RESPONSE TO THE DRAFT REPORT

Assurant Group
AMERICAN RELIABLE INSURANCE COMPANY
8655 E. Via de Ventura, Scottsdale, Arizona 85258
Phone (480) 483-8666 Fax (480) 607-7349

RECEIVED
MAY 8 11 55 AM '00
OFFICE OF SURETY GUARANTEES

May 5, 2000

Robert J. Moffitt
U.S. Small Business Administration
409 3rd Street SW
Washington, DC 20416

Re: Response to SBA Draft Audit Report

Dear Mr. Moffitt:

Our responses to the items contained in the SBA Draft Audit Report you provided me are included in this package. I have summarized the contents below including the page number the item is located on in the SBA draft audit report and indicated the corresponding attachments, if applicable.

Audit Items	Response/Attachment
Incomplete Underwriting Documentation Provided, pg 2	Noted
[Ex. 4] pg 2	See attachment 1
[Ex. 4] pg 3	See attachment 2
[Ex. 4] pg 4	See attachment 3
[Ex. 4] pg 4	See attachment 4
[Ex. 4] pg 5	See attachment 5
[Ex. 4] pg 5	See attachment 6

FOIA Ex. 4

[Ex. 4] pg 5		See attachment 7
[Ex. 4] pg 6		See attachment 8
[Ex. 4] pg 7		Noted
[Ex. 4] pg 7		See attachment 9

Please advise what the next step is in this process. You can reach me at ext. 380.

Sincerely,

Kathi Wiles

Kathi Wiles
Surety Department

FOIA Ex. 4

Attachment 1

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA EX. 4]

Facts as presented in Cotton audit report:

A) On [Ex. 4] American Reliable issued payment and performance bonds to [Ex. 4] each.

B) On [Ex. 4] American Reliable entered into a takeover agreement under terms of the performance bond after [Ex. 4] defaulted on the contract. Additional work was added to the takeover agreement totaling [Ex. 4] The additional work was previously part of a separate agreement between [Ex. 4] and the obligee, outside of the bonded contract.

C) American Reliable paid [Ex. 4] of losses and expenses (net of recoveries) under these bonds, of which the SBA guaranteed 80% or [Ex. 4]

D) American Reliable implicitly agreed to a material alteration in the bond, which was not approved by the SBA. As a result, it is recommended that American Reliable reimburse [Ex. 4] to the SBA.

We do not agree with the recommendations as presented in the Cotton draft audit report.

We find the audit report recommendation does not take into consideration that two bonds were issued, a payment bond and a performance bond. The audit report, by virtue of its reference to a takeover agreement, clearly points to an increase in liability under the performance bond. But, the audit report fails to present the source of the [Ex. 4] in losses and expenses. There is some cross over between payment and performance as to the source of the [Ex. 4] in losses and expenses. The performance bond loss totals [Ex. 4] (SBA share = [Ex. 4]) and the payment bond loss totals [Ex. 4] (SBA share = [Ex. 4]). However, an increase in the dollar amount of the work left to complete the performance of the original contract should not effect the SBA's liability under the payment bond. Therefore only the amount ([Ex 4]) incurred for losses and expenses that relates to the performance bond should be challenged as non-reimbursable by the SBA.

However, we believe the total loss amount should be guaranteed by the SBA. The audit report recommendation fails to consider American Reliable's obligation under section 115.37 of the Code, Minimization of loss. This section (a) states

FOIA EX. 4

"...Surety shall take all reasonable action to minimize risk of loss,...". Further, section 115.40 of the Code, Audits and investigations, section (c) (3) states one purpose of the audit shall determine "The minimization of loss, including the exercise of bond options upon contract default;...".

In order to mitigate the loss to ARIC and the SBA, ARIC determined it was more cost effective to include the additional unbonded work as an enhancement to the takeover contractor and the obligee. By including the additional work, we were able to mitigate our loss by obtaining a more competitive price from the takeover contractor. Further, the inclusion of additional items beyond the strict interpretation of the scope of the original bonded contract was beneficial in our negotiations with the obligee.

In addition, due to the sequencing of the remaining work, the bonded work could not have been completed without the prior or concurrent completion of the unbonded work. As a result, we would not have been able to cost effectively complete our obligations under the performance bond without completion of the unbonded work. Additional costs incurred in the completion of the unbonded work by ARIC more than offset the cost of damages accruing in their failure to complete the bonded work in a timely manner.

In compliance with section 115.37 of the Code, Minimization of loss ARIC took the above-mentioned actions in order to minimize the risk of loss. Therefore the SBA should guarantee the claims under both the payment and the performance bonds.

Attachment 2

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA EX. 4]

Our bank had trouble receiving a copy of the cancelled check so we have included a copy of the check we issued and a copy of the bank statement showing the check had been cashed as proof of payment on this item.

Check Date	Payee	Transaction	Check Number	Amount
[EX. 4]		Performance-Loss	[EX.4]	[EX. 4]

Attachment 3

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA Ex. 4]

Copies of our cancelled checks showing proof of payment are attached for the 8 checks totaling [Ex. 4] Where possible, we have obtained a copy of the cancelled check from our bank. The bank was unable to retrieve a copy of the cancelled check for check numbers [Ex. 4] and [Ex. 4] so we have included a copy of the check we issued and a copy of the bank statement showing the check has been cashed.

	Check Date	Payee	Transaction	Check Number	Amount
A	[	FOIA Ex. 4]	Expense	[	FOIA Ex. 4]
B			Expense		
C			Expense		
D			Expense		
E			Expense		
F			Expense		
G			Expense		
H			Expense		
					[Ex. 4]

FOIA Ex. 4

Attachment 4

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FoIA Ex. 4]

Copies of the cancelled checks showing proof of payment are attached for the 15checks totaling [Ex. 4]

	Check Date	Payee	Transaction	Check Number	Amount
A	[		Expense	[	]
B			Expense		
C			Expense		
D			Expense		
E			Expense	FoIA	
F			Pymt-Loss		
G		FoIA Ex. 4	Pymt-Loss	Ex. 4	
H			Pymt-Loss		
I			Pymt-Loss		
J			Expense		
K			Expense		
L			Expense		
M			Expense		
N			Expense		
O	]		Expense	]	[Ex. 4]

FoIA Ex. 4

Attachment 5

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA EX. 4]

Copies of our cancelled checks showing proof of payment are attached for the 28 checks totaling [EX. 4] The bank was unable to retrieve a copy of the cancelled check for check number [EX. 4] so we have included a copy of the check we issued and a copy of the bank statement showing the check has been cashed.

	Check Date	Payee	Transaction	Check Number	Amount
A	[		Expense	[	]
B		]	Expense		
C			Expense		
D			Expense		
E			Expense		
F			Expense		
G			Expense		
H		FOIA	Expense	FOIA	
I		EX. 4	Expense	EX. 4	
J			Expense		
K			Expense		
L			Expense		
M			Expense		
N			Expense		
O			Expense		
P			Expense		
Q			Expense		
R			Expense		
S			Expense		
T			Expense		
U			Expense		
V			Expense		
W			Expense		
X			Payment-Loss		
Y			Payment-Loss		
Z			Payment-Loss		
AA			Payment-Loss		
AB	[	]	Payment-Loss	[	]

FOIA EX. 4

Attachment 6

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FoIA Ex. 4]

Copies of our cancelled checks showing proof of payment are attached for 10 checks totaling [Ex. 4] The bank had trouble retrieving a copy of the cancelled check for check number [Ex. 4] so we have included a copy of the check we issued and a copy of the bank statement showing the check has been cashed.

Check number [Ex. 4] was issued but has not been cashed. A copy of the check we issued is attached.

	Check Date	Payee	Transaction	Check Number	Amount
A	[FoIA Ex. 4]		Expense	[FoIA Ex. 4]	
B			Expense		
C			Expense		
D			Expense		
E			Expense		
F			Expense		
G			Expense		
H			Pymt-Loss		
I			Expense		
J			Pymt-Loss		
K			Expense		

FoIA Ex. 4

Attachment 7

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA Ex. 4]

1. Copies of cancelled checks showing proof of payment are attached for the 7 checks totaling [Ex. 4]

	Check Date	Payee	Transaction	Check Number	Amount
A			Expense		
B			Pymt - Loss		
C		FOIA Ex. 4	Pymt - Loss		FOIA Ex. 4
D			Expense		
E			Pymt - Loss		
F			Pymt - Loss		
G			Pymt - Loss		
					[Ex. 4]

2. Facts as presented in Cotton audit report:

A) On [Ex. 4] American Reliable issued payment and performance bonds to [Ex. 4] for [Ex. 4] and [Ex. 4]

B) [Ex 4] of approved change orders were issued between [Ex. 4] [Ex. 4] increasing the total contract amount to [Ex. 4]

C) Due to default of the principal on [Ex 4] American Reliable entered into a takeover agreement, which incorporated the full contract amount of [Ex. 4] American Reliable paid [Ex. 4] in losses and expenses (net of recoveries) under these bonds.

D) American Reliable exceeded the [Ex. 4] in statutory limits after the bond's execution. As a result, it is recommended that American Reliable reimburse [Ex 4] in costs to the SBA due to the formula as prescribed in the Code.

In general, we disagree with the recommendations as presented in the draft copy of the Cotton audit report. We have based our points of disagreement on our interpretation of the Code of Federal Regulations, Business Credit and Assistance, Title 13, Revised as of March 1, 1996, Part 115-Surety Bond Guarantee ("the Code") and our experience in the analysis of losses in default situations.

FOIA Ex. 4

At first pass, it seems the recommendations presented in the audit report are relatively straightforward. However, as with the previous matter on [ex 4] there were two bonds issued to the principal. The payment bond is not represented in the audit report as exceeding the statutory SBA limits, only the performance bond. One cannot simply determine that all amounts were paid under the performance bond. The amounts paid under the payment bond were [ex. 4] The amounts paid under the performance bond were [ex. 4] Under the terms of these bonds the SBA should have paid 90% of the payment bond losses and according to the SBA's formula, 85% of the performance bond losses. In this case 90% of the payment bond losses is [ex. 4] 85% of the performance bond losses is [ex. 4] As a result the SBA would be liable for a total of [ex. 4] Consequently, it would appear the amount reimbursable to the SBA from the surety is [ex. 4]

FOIA EX. 4

Attachment 8

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA EX. 4]

Copies of our cancelled checks showing proof of payment are attached for the 7 checks totaling [EX. 4]

	Check Date	Payee	Transaction	Check Number	Amount
A	[	FOIA EX 4	Expense	[	EX. 4]
B			Payment-Loss		
C			Performance-Loss		
D			Payment-Loss		
E			Payment-Loss		
F			Payment-Loss		
G	]		Expense	]	
					[EX. 4]

FOIA EX. 4

Attachment 9

American Reliable Insurance Company
SBA Draft Audit Response
5/5/2000

[FOIA EX. 4]

Facts as presented in Cotton audit report:

A) It appears that a SBA guaranteed bond was issued to [ex.4] Further, it appears that as part of the requirements for this bond's execution, a [ex.4] certificate of deposit was represented as taken for collateral.

B) The collateral is no longer held by American Reliable, and was not netted against claims submitted to the SBA.

C) It is recommended that American Reliable reimburse the SBA [ex.4] for claims previously paid, and be responsible for future claim reimbursements under the bond of [ex.4] (The total of these two amounts is [ex.4] 80% of the [ex.4] certificate of deposit previously held for collateral.).

It appears there is conflicting information in the audit report. The following statements are from the audit report:

1. "SBA Form 994B, Surety Bond Guarantee Underwriting Review, states that the surety required additional security in the form of a [ex.4] certificate of deposit."

   We have reviewed our records and find no copy of the 994B form referenced. We do have copies of correspondence showing we requested a copy of this form from both the agent and the SBA.

2. "American Reliable was not aware of the collateral when it processed claims under the bond, and therefore did not pursue its right to liquidate the collateral as part of its recovery efforts."

   We have reviewed our records and found no evidence that collateral was provided to us on this bond.

3. "In a [ex.4] letter to SBA, American Reliable requested that SBA process claims under SBG No. [ex.4] less the [ex.4] representing the collateral."

   We have reviewed our records and did not find a copy of this referenced letter. Please provide us with a copy.

FOIA EX. 4

4. "The collateral was not netted against claims submitted on the SBA Form 994H.".

The file along with previous reporting to SBA indicates that [ex. 4] was in fact distributed to payment bond claimants and the remaining amount of [ex. 4] was forwarded to us and shown as a recovery on our first report to SBA as a recovery. Our documentation does not specify whether or not these funds are collateral.

Based on this seemingly conflicting information, we respectfully request that the SBA review the information they have on this item and provide us with copies of the 994B form and the [ex. 4] letter referencing the collateral. These documents are required to assist us with further research into this matter.

FOIA EX. 4

Assurant Group

AMERICAN RELIABLE INSURANCE COMPANY
8655 E. Via de Ventura, Scottsdale, Arizona 85258
Phone (480) 483-8666 Fax (480) 607-7349

RECEIVED
JUN 26 11 44 AM '00
OFFICE OF SURETY GUARANTEES

RECEIVED
JUN 26 11 44 AM
OFFICE OF SURETY GUARANTEES

June 23, 2000

Robert J. Moffitt
U.S. Small Business Administration
409 3rd Street SW
Washington, DC 20416

Via Fax: 202-205-7600

Re: Response to SBA Draft Audit Report
[FOIA Ex 4]

Dear Mr. Moffitt:

The 994B form that was provided to us from Cotton & Company does reference a [Ex. 4] as collateral. A review of our files does not reveal any collateral submitted to us on this bond ([Ex. 4]). Based on the 994B for the SBA believes it should be reimbursed the [Ex. 4] it paid ARIC and that ARIC be responsible for future claim reimbursements of [Ex. 4] under this bond.

As stated in [Ex. 4 & 6] letter dated [Ex. 4] to [Ex. 4 & 6] we requested that the claim be processed less the alleged [Ex. 4] collateral. It appears that a corrected 994H form was not submitted after [Ex 4 & 6] [Ex. 4] correspondence to [Ex. 6] so the requested adjustment was not made.

ARIC will reimburse the [Ex. 4] received from the SBA and will offset the next [Ex. 4] of claims incurred on this bond. Please let me know where the check should be sent and I will see that it is issued and mailed as soon as possible.

Sincerely,

Kathi S. Wiles

Kathi Wiles
Surety Department

/kw

cc: [FOIA Ex. 6]

FOIA Ex. 4 & 6

Appendix B

REPORT DISTRIBUTION

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