AUDIT OF FIDELITY AND DEPOSIT COMPANY

OF MARYLAND

BALTIMORE, MARYLAND

AUDIT REPORT NO. 9-06

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

AUDIT REPORT
Issue Date: March 22, 1999
Report Number: 9-06

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

/s/ Original Signed
FROM: Peter L. McClintock
Assistant Inspector General for Auditing

SUBJECT: Audit Report – Fidelity and Deposit Company of Maryland

Attached is a copy of the subject report. The report contains three findings and nine recommendations.

The findings 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 decision for each recommendation within 80 days on the attached SBA Forms 1824, Recommendation Action Sheet. If you disagree with the recommendation, please provide your reasons in writing.

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

Audit of Fidelity and Deposit Company of Maryland
Baltimore, Maryland

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SUMMARY

We completed an audit of the Fidelity and Deposit Company of Maryland (F&D). Our objectives were to determine whether: (1) F&D complied with SBA underwriting policies; (2) F&D claims, expenses, and recoveries were in accordance with SBA requirements; and (3) F&D fee remittances and refunds were timely and accurate.

The auditors concluded that F&D: (1) did not always follow SBA procedures for underwriting; and (2) did not always follow requirements related to claims, expenses, and recoveries. As a result, SBA was due $1,353,579 -- $979,613 related to underwriting and $373,966 related to claims, expenses, and recoveries. F&D has paid or has agreed to pay $1,124,330. We also found $86,775 in erroneous fee refunds made to contractors who obtained bonds from F&D and that F&D's suspense account contained fees that were owed to SBA and contractors.

We discussed the results of our audit with SBA and F&D officials during an exit conference held at F&D's headquarters on November 10, 1998. On February 17, 1999 we received written comments from F&D generally agreeing with our findings and recommendations with a few exceptions (see Appendix D for F&D's response). We have deleted some or all of the findings and recommendations associated with [FOIA ex. 4]. The Associate Administrator, Office of Surety Guarantees (AA/OSG) verbally agreed with our findings and recommendations.

We recommend that F&D be required to: (1) document project start dates and include copies of the SBA Form 994 and bonded contract in its files for all future SBA guaranteed bonds; (2) remit $1,005 to SBA on one of [FOIA ex. 4, 6] bonds; (3) remit to SBA $42,700, which represents 70 percent of the uncollected portion of the note for [FOIA ex. 4, 6] (4) remit $635 to SBA for [FOIA ex. 4] due to the improper allocation of expenses; (5) pursue the indemnitors of [FOIA ex. 6] to recover the losses which includes SBA's portion totaling $212,334, and remit to SBA its share of the recoveries; (6) remit to SBA, within the required 90 days, its share of any future recoveries/salvage received; (7) use its best efforts to assist SBA in identifying those contractors who received the erroneous contractor fee refunds and the amount of refunds that would have been made; (8) remit to the contractors the remaining $4,105 in SBA contractor fees for bonds issued without an SBA guarantee; and (9) remit the remaining $166 in fees due SBA that were in the SBA suspense account.

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

INTRODUCTION

A. BACKGROUND

Federal construction contracts of $100,000 or more, as well as certain private, state and local government contracts, require contractors to be bonded. Surety bonds ensure that should a bonded contractor default, a construction project will be completed and the contractor's employees and material suppliers will be paid. SBA guarantees bonds for construction and service contracts up to $1,250,000 if (1) the principal is a small business, (2) the bonds are required to obtain the contract, and (3) the business is unable to obtain a bond without the SBA guarantee. SBA certifies "preferred" surety companies to issue, monitor, and service SBA guaranteed bonds without SBA's prior review and approval. SBA reimburses a preferred surety an amount not to exceed 70 percent of the loss incurred and paid.

Fidelity and Deposit Company of Maryland, located in Baltimore, Maryland, was granted preferred surety status in May 1990. Through September 1998, F&D issued 3,304 SBA guaranteed bonds valued at approximately $707 million.

See Appendix B for a follow-up on prior audits and Appendix C for a glossary of terms used throughout this report.

B. AUDIT OBJECTIVE AND SCOPE

The audit objectives were to determine whether (1) F&D complied with SBA underwriting policies; (2) F&D claims, expenses, and recoveries were in accordance with SBA requirements; and (3) F&D fee remittances and refunds were timely and accurate. From October 1992 through June 1997, F&D reported 101 defaulted bonds related to 52 contractors totaling approximately $6.3 million in claims and expenses. We reviewed claims that included all contractors with total claim losses exceeding $50,000. This represented 51 bonds related to 18 contractors totaling approximately $5.4 million or 85.5 percent of the dollar value of all claims and expenses in the period.

Fieldwork was conducted from April 30, 1997, through June 5, 1998, at F&D's offices in Baltimore, Maryland. When the fieldwork started, the auditor found that F&D could not provide auditable accounting records. For example, F&D was initially unable to produce a report of all losses, expenses, and salvage for the bonds audited when asked by the auditor. F&D subsequently remedied this problem and the report was generated. The auditor also found that F&D had not reconciled its database of loss and expense records with the monthly bordereau submitted to SBA during approximately the first seven years that it was in the preferred surety bond program. As a result, F&D and SBA did not have reasonable assurance that the amounts billed to SBA were accurate.

F&D was very cooperative throughout the audit and was proactive in implementing numerous corrective actions to remedy problems identified during the audit. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Of the 51 bonds reviewed, 27 had deficiencies in one or more of the following areas: a) underwriting (18 bonds); b) claims, expenses, and recoveries (17 bonds); and c) fee remittances and refunds (5 bonds). As a result, SBA was due \$1,353,579 -- \$979,613 related to underwriting and \$373,966 related to claims, expenses, and recoveries. F&D has paid or has agreed to pay \$1,124,330. Appendix A provides a discussion of each of the above bonds, with the exception of the findings for two companies previously reported on, [FOIA ex. 4, 6] (see audit report 7-7-H-006-025).

FINDING A: F&D Did Not Follow SBA Procedures For Underwriting

For 18 of the 51 bonds reviewed, F&D did not follow certain established policies and procedures for underwriting. Specifically, F&D (1) reported bond execution to SBA in an untimely manner; (2) failed to obtain the required SBA Form 912, which certifies whether any of the obligees has a criminal record; (3) did not follow its own underwriting standards; (4) did not document project start dates; (5) did not have a copy of the SBA Form 994 "Application for Surety Bond Guarantee Assistance;" and (6) did not have a copy of the bonded contract. As a result, SBA paid F&D \$979,613 in unallowable claims and expenses, of which F&D has reimbursed \$984,059.

The chart on the following page identifies the underwriting deficiencies by contractor. Columns A – F show the number of bonds with a particular type of deficiency.

Underwriting Deficiencies

CONTRACTOR	No. Bonds With Claims	A	B	C	D	E	F	Amount Due SBA	Amount Paid	Remaining Amount Due SBA
[FOIA ex. 4, 6]	8				8			$0	$0	$0
[FOIA ex. 4]	2		1					$0	$0	$0
[FOIA ex. 4, 6]	6					1	1	$0	$0	$0
[FOIA ex. 4]	6	1						$6,682	$6,682	$0
[FOIA ex. 4, 6]	2	1						$95,218	$95,218	$0
[FOIA ex. 4, 6]	3		3					$10,771	$10,771	$0
[FOIA ex. 4, 6]	1	1						$293,950	$295,013*	$0
[FOIA ex. 4, 6]	1			1				$572,992	$576,375*	$0
Totals	29	3	4	1	8	1	1	$979,613	$984,059	$0

* These numbers are based on SBA's loss balance as of December 1997, whereas the numbers in the "Amount Due SBA" column are based on SBA's loss balance from a different date.

Legend of Deficiencies

A Bond execution was not reported timely to SBA as required by The Preferred Surety Bond Guarantee Agreement.
B SBA Form 912 was not obtained as required by The Information Book of the Preferred Surety Bond Program.
C F&D did not follow its own underwriting standards.
D Project start date was not documented as required by Title 13 CFR 115.
E SBA Form 994 was missing in violation of Title 13 CFR 115.
F Copy of the contract was missing in violation of Title 13 CFR 115.

Recommendation

A01. We recommend that the Associate Administrator, Office of Surety Guarantees, notify F&D to document project start dates and include copies of the SBA Form 994 and bonded contract in its files for all future SBA guaranteed bonds.

Auditee Comments

F&D did not comment on this particular recommendation and the corresponding deficiencies.

FINDING B: F&D Did Not Follow Requirements Related To Claims, Expenses, And Recoveries

For 17 of the 51 bonds reviewed, F&D did not follow certain established policies and procedures related to claims, expenses, and recoveries. Specifically, F&D did not (1) collect outstanding contract balances, (2) document the contract balances, (3) adequately pursue indemnitors, (4) remit recoveries in a timely manner, (5) ensure that claims or expenses were allocable to SBA guaranteed bonds, and (6) remit the correct recovery amount to SBA. As a result, SBA is due $373,966, of which F&D has paid or has agreed to pay $140,271.

The following chart identifies the claim, expense, and recovery deficiencies by contractor. Columns A – F show the number of bonds with a particular type of deficiency. Some bonds have more than one type of deficiency.

Deficiencies Related To Claims, Expenses, And Recoveries

CONTRACTOR	No. Bonds With Claims	A	B	C	D	E	F	Amount Due SBA	Amount Paid/Agreed To Pay	Remaining Amount Due SBA
[FOIA ex. 4, 6]	8	2	2	8			1	$91,162	$68,807	$22,355
[FOIA ex. 4]	2	1						$5,227	$6,256*	$0
[FOIA ex. 4, 6]	6	1						$972	$937	$35
[FOIA ex. 4]	2					1		$635	$635	$0
[FOIA ex. 4, 6]	1			1				$212,334	$0	$212,334
[FOIA ex. 4, 6]	2				1			$42,153	$42,153	$0
[FOIA ex. 4, 6]	3				3			$14,000	$14,000	$0
[FOIA ex. 4]	1				1			$7,483	$7,483	$0
Totals	**25**	**4**	**2**	**9**	**5**	**1**	**1**	**$373,966**	**$140,271**	**$234,724**

* SBA's amount was based on its share of F&D's collecting a final contract balance of $7,467. F&D actually collected $8,937 and paid SBA its share, $6,256.

Legend of Deficiencies

A Contract balances were not collected as required by F&D's Claim Department Policies and Procedures Manual 100.
B Contract balances were not documented as required by F&D's Claim Department Policies and Procedures Memorandum 348.1.
C Indemnitors were not adequately pursued in accordance with F&D's Claim Department Policies and Procedures Manual 100.
D Salvage or recoveries were not submitted to SBA in a timely manner as required by The Preferred Surety Bond Guarantee Agreement.
E Unallocable claims or expenses were paid in violation of Title 13 CFR 115.
F Incorrect recovery amount was remitted to SBA in violation of The Preferred Surety Bond Guarantee Agreement.

Recommendations

We recommend that the Associate Administrator, Office of Surety Guarantees, notify F&D to:

B01. Remit $1,005 to SBA for [FOIA ex. 4, 6] bond [FOIA ex. 2] due to the incorrect recovery amount remitted to SBA.

B02. Remit to SBA $42,700, which represents 70 percent of the uncollected portion of the note for [FOIA ex. 4, 6]

B03. Remit $635 to SBA for [FOIA ex. 4] bond [FOIA ex. 2] due to the improper allocation of expenses.

B04. Pursue the indemnitors of [FOIA ex. 6] to recover the losses which includes SBA's portion totaling $212,334, and remit to SBA its share of the recoveries.

B05. Remit to SBA, within the required 90 days, its share of any future recoveries/salvage received.

Auditee Comments

F&D provided the following comments in response to our finding and recommendations:

B01. F&D remitted the proper amount ($2,832.97) to SBA for this claim. "This amount ($2,832.97) was the net difference between SBA's portion of the salvage ($3,937.47) and the SBA's portion of the losses ($1,004.50). The assertion that the SBA was entitled to all of the $3,937.47 fails to take into account the losses (totaling $1,004.50), which F&D properly applied as an offset against the salvage."

B02. "F&D acknowledges that it did not adequately pursue collection against the individual indemnitors." One of the indemnitors declared bankruptcy in which there were no assets and all debts were discharged effective January 1998. The other indemnitor lives on a fixed income and "has been encumbered by tax and other debts as a result of her relationship" with her ex-husband. "Accordingly, even if F&D had vigorously pursued its rights under the note, it appears that the recovery would have been nominal, if any. Notwithstanding, F&D agrees to credit the SBA $21,350 on the theory that it would have been able to recover a maximum of 50% (or $30,500) on the unpaid portion of the note."

B03. F&D previously agreed to reimburse SBA $635 on this bond.

B04. "This claim was handled in compliance with F&D's claim handling procedures. F&D intentionally waited to pursue the indemnitors for several reasons." F&D needed one of the indemnitor's cooperation to close out a very difficult job resulting in a deductive change order on the contract for about $21,500 less than the amount the owner has requested. It is F&D's understanding that the indemnitors (husband and wife) have no assets of significant value other than their residential real estate, which is not reachable by creditors under Texas law. Currently, F&D is pursuing its indemnitors and has proposed that they execute a promissory note for $192,620 in favor of F&D. "On the basis of their current financial condition, F&D has offered to accept monthly payments of $100 on this obligation and to credit the indebtedness $200 for every $100 that is paid. The payment terms are re-negotiable every five years, or more often should circumstances change that will permit the indemnitors to make large payments. F&D will cede the SBA's portion of any recovery to the SBA in accordance with the governing regulations."

B05. F&D did not comment on this particular recommendation.

Evaluation of Auditee Comments

B01. We disagree with F&D that no funds are due SBA for $1,004.50. An SBA official advised the auditor that in July 1993, the claims procedure did not provide for recoveries to be netted with claims. SBA's records show a separate claim paid for $1,004.50 and separate recovery received for $2,832.97 (we added an additional clarifying sentence to the finding in Appendix A). If SBA was incorrect and F&D did net the loss with the recovery, SBA is still due $1,004.50 because SBA paid the $1,004.50 claim separately.

B02. Although F&D agrees that collection was not adequately pursued against the indemnitors, there still is disagreement over the amount that F&D would have been able to recover. We believe the AA/OSG should determine whether the compromise credit of $21,350 would be acceptable to SBA.

B03. The auditee's proposed action is responsive to our recommendation.

B04. Based on F&D's response, we added additional information to the finding in Appendix A and clarified our position pertaining to the pursuit of the indemnitors. F&D's agreement to cede SBA's portion of any recovery to SBA is responsive to our recommendation.

FINDING C: Fee Remittances and Refunds

Fee Refunds Resulting From F&D's Cancellation of Bonds

At least $86,775 in erroneous fee refunds were made to contractors who obtained bonds from F&D. In 1992, F&D canceled certain bonds for completed jobs in its internal system as part of its routine business practice. Specifically, F&D's practice was to cancel bonds from its system when a bond was not needed (voided bond) or when a bonded contract was satisfied and no further obligation existed. The F&D bond cancellation entry also triggered cancellation of the same bonds in SBA's computer system due to the interface between the F&D and SBA systems. A cancellation in SBA's system was defined to result in an SBA liability. Therefore, SBA's system automatically generated fee refund checks for the premiums and contractors' fees for these bonds. The checks for the premiums were sent to F&D. The checks for the contractors' fees were sent to the contractors and, in a limited number of cases, to F&D. F&D stated that it was unaware that SBA's system defined all cancellations as voided bonds, requiring refunds to the surety and contractors. Of the $86,775 in contractor fee refunds, $9,660 was related to five bonds in our audit sample.

CONTRACTOR	REFUND AMOUNT	BOND NUMBER
[FOIA ex. 4, 6]	$1,344	[FOIA ex. 2]
[FOIA ex. 4, 6]	$1,860	[FOIA ex. 2]
[FOIA ex. 4]	$228	[FOIA ex. 2]
[FOIA ex. 4, 6]	$252	[FOIA ex. 2]
[FOIA ex. 4, 6]	$5,976	[FOIA ex. 2]

F&D stated that upon discovering the effect of these cancellations and prior to the initiation of this audit, F&D returned to SBA the erroneous premiums and contractor fees that it received. F&D, however, was not aware of the contractor fee refunds that SBA made directly to contractors until brought to their attention during this audit. F&D paid SBA $5,976 for the erroneous refund made to [FOIA ex. 4, 6]using excess recoveries received. F&D has agreed to use its best efforts to assist SBA in identifying those contractors who might have received such refunds and the amount of the refunds that would have been made. F&D also reinstated the canceled bonds through its direct communication link with SBA's computer system and directed its associates to not cancel satisfied/expired bonds on the SBA computer system.

These events resulted from the difference between how F&D's computer system and SBA's computer system defined "cancellation of bonds." There was no violation of SBA regulations or policies. Moreover, F&D agreed to take appropriate actions to assist SBA in recovering these funds.

Contractors Entitled To Fee Refunds

F&D received $110,503 in SBA contractor fees for several bonds which F&D intended to issue with an SBA guarantee. F&D then decided to issue the bonds without an SBA guarantee. However, F&D did not return the SBA contractor's fees to the contractors. Instead, these fees remained in F&D's suspense account. As a result of the audit, F&D stated that it had repaid $106,398 of these contractors' fees to the contractors. F&D stated that with respect to the balance, F&D is attempting to identify the contractors and bonds for which these refunds should be made and will make these refunds to the extent that it is able to ascertain this information.

SBA Entitled To Fee Refunds

F&D's suspense account also contained $2,219 in fees due SBA. As a result of the audit, F&D stated that it had paid $2,053 of that amount to SBA. F&D also stated that it was working with SBA so that the remaining balance can be paid to

SBA and be properly recognized in the SBA system. A contributing factor to this deficiency was that F&D had not reconciled its SBA suspense account since it entered the SBG Program in 1990. During the audit, F&D agreed to review the SBA suspense account monthly and to reconcile the account annually.

Recommendations

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

C01. Notify F&D to use its best efforts to assist SBA in identifying those contractors who received the erroneous contractor fee refunds and the amount of refunds that would have been made.

C02. Notify F&D to remit to the contractors the remaining $4,105 ($110,503 – $106,398) in SBA contractor fees for bonds issued without an SBA guarantee.

C03. Verify that SBA received $2,053, and notify F&D to remit the remaining $166 ($2,219 - $2,053) in fees due SBA that were in the SBA suspense account.

Auditee Comments

F&D stated that "with respect to the $106,398.40 in fees which F&D has refunded to contractors, the SBA requested and F&D has provided to the SBA sample documentation of these repayments."

Evaluation of Auditee Comments

We have reviewed the sample documentation of these repayments and concluded that the repayments were made.

OTHER MATTER: Unbilled Claims

When F&D performed its first reconciliation, it found unbilled claims to SBA totaling $119,425 that were more than one year old. Title 13 CFR 115 requires that a preferred surety must submit claims for reimbursement no later than one year from the date the surety paid the amount. Thus, SBA is not obligated to reimburse F&D for the unbilled claims paid. The AA/OSG stated a waiver could be approved if F&D provided documentation (e.g. invoices) and justification for the untimely claims. During the audit, F&D agreed to review its claim and fee records on a quarterly basis and to reconcile the accounts annually.

Appendix A

FINDINGS ON INDIVIDUAL CONTRACTORS

[FOIA ex. 4]

Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]
Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]

F&D did not collect outstanding contract balances of $59,827 (SBA share $41,879) and $7,968 (SBA share $5,578) from the obligees. Title 13 CFR 115 requires "preferred" sureties to issue and administer SBA guaranteed bonds in the same manner as non-SBA guaranteed bonds. As a result, F&D was required to follow its internal policies and procedures. F&D Claim Department Policies and Procedures Manual 100 required F&D to fully pursue all legal and equitable rights and remedies to which F&D is entitled to recover. F&D stated that the contract balances were overlooked during an office reorganization and subsequently credited SBA $47,457 as a result of the audit.

Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]
Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]

F&D did not have adequate support for the contract balances. On the first contract, an F&D memo showed the contract balance as $3,136. On the second contract, an F&D loss estimation showed an F&D payment of $69,925 to the contractor and a remaining contract balance of $4,569. We did not find any documentation to support the $69,925 payment or any other documentation to provide assurance that the contract balances were accurate. F&D Claim Department Policies and Procedures Memorandum 348.1 required that F&D obtain a copy of the last approved and paid 'pay requisition', a copy of any approved and unpaid requisition, and a copy of any unapproved requisition. Since the obligee paid F&D $3,136 on the first contract and $4,569 on the second contract, we did not dispute the contract balances and will not recommend repayment of funds on this basis.

Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]

F&D did not remit SBA the proper amount for a recovery received as required by the Preferred Surety Bond Guarantee Agreement. Specifically, the July 1993 bordereau listed SBA's share of a recovery as $3,837.47 and SBA's share of a claim as $1004.50. SBA records indicate that SBA received only $2,832.97 for this recovery, a difference of $1004.50. However, SBA records also listed separately, a claim paid for $1004.50.

Bond Numbers:	*Claim Numbers:*	*PSB Numbers:*
[FOIA ex. 2]	[FOIA ex. 2]	[FOIA ex. 2]

F&D did not adequately pursue collection against the individual indemnitors as required by F&D Claim Department Policies and Procedures Manual 100. F&D obtained a note for approximately $65,000 from the indemnitors that required monthly payments of $2,000. After two payments, the indemnitors stopped making payments and F&D did not pursue further collection. We found no evidence that the indemnitors filed for personal bankruptcy or justification as to why F&D did not pursue further collection. F&D stated it has requested information concerning the indemnitors' financial condition to assess what amount might have been collectible on the note. F&D stated that they will propose a compromise credit to SBA for this potential salvage once the information is obtained. SBA's share of the uncollected $61,000 is $42,700.

Also, F&D did not document the actual project start date for the eight bonds. Title 13 CFR 115.60 (c) (1992 edition) requires that the sureties document compliance with SBA regulations and retain such certifications in its files. F&D agreed to document the project start dates and to verify that work has not started prior to bond issuance.

[FOIA ex. 4]

Bond Number [FOIA ex. 2]	*Claim Number* [FOIA ex. 2]	*PSB Number* [FOIA ex. 2]

F&D executed this bond without obtaining the required SBA Form 912 for a new 40 percent owner of the business. In a program review, dated November 10, 1994, SBA informed F&D that --

> the surety must obtain the SBA Form 912 and document the file so eligibility can be determined. Otherwise, the principal is not eligible.

We found no documentation indicating that SBA followed-up to determine if F&D complied with the requirement prior to paying the claim. During the audit, we requested that F&D obtain the Form 912 for the new principal. F&D obtained the Form 912. A criminal history check of the Form 912 conducted by SBA OIG Investigations Division revealed two minor offenses that should have been disclosed on his Form 912. However, the nondisclosure would not have excluded the new owner from obtaining a surety bond guarantee. As a result, we will not recommend repayment of funds on this basis.

In addition, F&D did not originally collect an outstanding contract balance of $7,467 (SBA share $5,227) as required by F&D Claim Department Policies and

Procedures Manual 100. F&D stated that this was an oversight. F&D collected $8,937 (more than the remaining contract balance) and paid SBA $6,256 on December 17, 1997.

[FOIA ex. 4, 6]

Bond Number [FOIA ex. 2]	*Claim Number* [FOIA ex. 2]	*PSB Number* [FOIA ex. 2]

F&D records showed an outstanding contract balance of $1,388 (SBA share $972) was not collected as required by F&D Claim Department Policies and Procedures Manual 100. Also, F&D's underwriting file did not contain a copy of the SBA Form 994 as required by Title 13 CFR 115. Due to the audit, F&D subsequently reimbursed SBA $937.

Bond Number [FOIA ex. 2]	*Claim Number* [FOIA ex. 2]	*PSB Number* [FOIA ex. 2]

F&D's underwriting file did not contain a copy of the bonded contract as required by Title 13 CFR 115.

[FOIA ex. 4]

Bond Number [FOIA ex. 2]	*Claim Number* [FOIA ex. 2]	*PSB Number* [FOIA ex. 2]

F&D did not report the bond execution to SBA in a timely manner as required by the Preferred Surety Bond Guarantee Agreement. The bond was executed on April 20, 1992, and was reported to SBA five months later on September 18, 1992. The project was completed as of September 11, 1992, prior to SBA notification. F&D stated it was always their intention that the bond be SBA guaranteed. F&D noted that [FOIA ex. 4] had obtained other SBA guaranteed bonds from F&D. As of June 30, 1997, SBA's share of the losses totaled $6,682. Due to the audit, F&D subsequently reimbursed SBA $6,682 for its share of the losses.

[FOIA ex. 4]

Bond Number [FOIA ex. 2]	*Claim Number* [FOIA ex. 2]	*PSB Number* [FOIA ex. 2]

F&D claimed expenses that were not allocable to the SBA bonded contract. Title 13 CFR 115.64 (b) (6) (1991 edition) states that SBA may deny liability when the loss occurred under a bond that was not guaranteed by SBA. F&D paid $907 to a vendor who performed work on another project not subject to SBA's guarantee. As a result, SBA paid $635 that was not allocable to the bond that SBA guaranteed. F&D could not provide an explanation on how the oversight occurred. F&D agreed to credit SBA $635 on this bond.

[FOIA ex. 4, 6]

Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]

F&D did not fully pursue collection of the loss from the indemnitors in a timely manner as required by F&D Claim Department Policies and Procedures Manual 100. Final payment of contract balances was made to F&D on August 11, 1997. On October 14, 1997, F&D stated in their claim management system that they "will make demand on our indemnitor." However, F&D did not send a demand letter to the indemnitors until approximately one year later in October 1998. In a June 15, 1998 letter to the auditor summarizing F&D's collection efforts, F&D's Houston claims attorney stated that until just recently, the indemnitors/owners could not be located. F&D only learned of the indemnitor's whereabouts through F&D's engineering consultant, who the indemnitor contacted on an unrelated matter. We found no evidence to suggest that F&D was trying to locate the indemnitors prior to learning about the indemnitor's whereabouts from the engineering consultant. F&D is currently negotiating a promissory note with the indemnitors. As of June 30, 1997, SBA's share of the losses totaled $212,334.

[FOIA ex. 4, 6]

Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]

F&D did not report the executed bond information to SBA within 10 business days as required by the Preferred Surety Bond Guarantee Agreement. The bond was executed on July 13, 1994, and reported to SBA almost three months later on October 5, 1994. F&D stated that the delay in reporting the bond to SBA was due to delays in receiving Forms 1624 "Certification Regarding Debarment, Suspension, Ineligibility and Voluntary Exclusion Lower Tier Covered Transactions" and 1261 "Statements Required by Laws and Executive Orders" from an F&D branch office. F&D also stated that they always intended to place this bond in the SBA program, so the untimely notification should not be a basis for denial of liability. There was no evidence to indicate that SBA had agreed to the reporting delay. As a result, SBA guaranteed an ineligible bond and as of February 1999, SBA's share of the losses totaled $95,218. Due to the audit, F&D subsequently reimbursed SBA $95,218 for the losses.

[FOIA ex. 4, 6]

Bond Number [FOIA ex. 2]	Claim Number [FOIA ex. 2]	PSB Number [FOIA ex. 2]

F&D did not remit SBA's share of salvage in a timely manner. The Preferred Surety Bond Guarantee Agreement requires the surety to reimburse SBA with its share of any recovery or salvage within 90 days of any such recovery or salvage by the surety. F&D recovered $60,219 (SBA's 70% share was $42,153) in contract funds on May 5, 1997. As a result of the audit, on December 18, 1997, over 7 months later, F&D remitted the $42,153 to SBA. F&D stated that recoveries were not remitted to SBA on a timely basis because SBA had not paid F&D for a large number of items billed, and it was their custom and practice with reinsurance accounts to withhold distribution of the salvage under such circumstances. After receipt of recovery amount, SBA had no losses related to the bond.

[FOIA ex. 4, 6]

Bond Number	[FOIA ex. 2]	*Claim Number*	[FOIA ex. 2]	*PSB Number*	[FOIA ex. 2]

Bond Number	[FOIA ex. 2]	*Claim Number*	[FOIA ex. 2]	*PSB Number*	[FOIA ex. 2]

Bond Number	[FOIA ex. 2]	*Claim Number*	[FOIA ex. 2]	*PSB Number*	[FOIA ex. 2]

F&D did not remit to SBA its share of salvage in a timely manner as required by the Preferred Surety Bond Guarantee Agreement. F&D sued the principal and indemnitors and settled for the payment of $20,000 in September and October 1996. Due to the audit, F&D remitted to SBA its share of the recovery ($14,000) on December 18, 1997, almost 15 months after the recovery. As a result, of the receipt of this recovery and other adjustments, SBA's share of the losses on all three bonds was $10,771 as of July 1, 1998.

The SBA Form 912s were missing for one partner and improperly processed for the other partner. The Information Book of the Preferred Surety Bond Program states that should an individual answer positively to questions 6, 7, or 8, the surety must contact the SBA Office of Surety Guarantees for an eligibility determination. The Information Book also requires the surety to obtain a completed SBA Form 912 for each partner in a partnership. Specifically, F&D obtained a completed Form 912 for one partner who indicated that he was presently under indictment, on parole or probation. There was no evidence that F&D contacted the SBA Office of Surety Guarantees for an eligibility determination. Subsequent to the audit fieldwork, F&D stated that they initiated an investigation that revealed this contractor had no criminal record in the jurisdictions searched. F&D stated that they will forward the written report to SBA once it is received. Also, F&D did not obtain an SBA Form 912 for the other partner and was unable to determine this partner's eligibility for the SBA bond guarantee. Subsequent to the audit fieldwork, F&D stated that they initiated an investigation that revealed the partner had a prior criminal record. F&D stated that they were unaware of this information when the bonds were submitted for inclusion in the SBA program. Due to the audit, F&D subsequently reimbursed SBA $10,771 for its share of the losses.

[FOIA ex. 4]

Bond Number [FOIA ex. 2]	*Claim Number* [FOIA ex. 2]	*PSB Number* [FOIA ex. 2]

F&D did not remit to SBA its share of salvage in a timely manner as required by the Preferred Surety Bond Guarantee Agreement. In May 1997, F&D collected the contract balance of $10,690 from the obligee. Due to the audit, F&D remitted to SBA its share of the recovery ($7,483) on December 18, 1997, almost seven months after the recovery.

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Appendix B

FOLLOW-UP ON PRIOR AUDITS

The Office of Inspector General has issued four prior audit reports related to F&D's operations. The first report, issued in October 1992, cited oversight weaknesses by F&D over its branch offices. In addition, the report stated that F&D's policies related to contractor financial performance were more stringent than required by SBA. F&D officials took appropriate action during the course of the audit; therefore no recommendations were made in the report.

The second report, issued January 1997, found that F&D was not requiring contractors to complete the SBA Form 994 "Application for Surety Bond Guarantee Assistance" in its entirety for the SBA bond guarantee. The report recommended that SBA provide clarification to preferred sureties stating that the SBA Form 994 should be completed in its entirety for the initial surety bond guarantee and if an alternative form is used for subsequent application, it should require similar information and certification as the SBA Form 994. The AA/OSG agreed and implemented our recommendations.

The third report, issued February 1997, found that F&D issued SBA guarantees for ineligible contracts. These guarantees were ineligible because of contract splitting and commencement of work prior to issuance of the bond guarantee. In addition, we reported that F&D did not document the actual start date for projects. We made the following four recommendations to SBA:

- notify F&D that SBA will deny liability on certain bonds;
- notify F&D to follow established procedures prohibiting splitting of contracts;
- notify F&D to establish procedures which ensure that bonds are not issued after work has commenced, unless they obtain SBA approval; and
- follow-up with F&D to ensure that their proposed procedures to identify actual start dates have been implemented.

The AA/OSG agreed with these recommendations.

The fourth report, issued September 1997 (revised) as part of this audit, found that F&D issued a bond to [FOIA ex. 4, 6] which was reported to SBA on an untimely basis and a bond to [FOIA ex. 4, 6] without following F&D underwriting standards. F&D withdrew the bonds and refunded $871,387 upon becoming aware that the bonds did not qualify for a SBA guarantee.

GLOSSARY

Bond	An agreement whereby one party, called the surety, obligates itself to a second party called the obligee, to guarantee the successful performance of a contract by a third party, called the principal.
Bordereau	A document submitted monthly to SBA by the surety which lists the PSB number, surety's claim number, date of claim, contractor name, claim and expenses paid and SBA's share of claim and expenses paid.
Claim	An amount requested of an insurer by a policyholder or a claimant for an insured loss.
Contract Balance	Bonded contract price plus/minus any approved change orders, minus any payments made by the obligee to the contractor.
Guaranty	An undertaking or contract to assume the liability for a debt, to perform a duty upon the default of another, or in general to give assurance that a thing will be done, or an obligation completed as promised. It provides that the guarantor will be liable for the failure to perform.
Indemnitor	A person or company which agrees with a surety to hold surety harmless from any loss or exposure incurred on a bond that it issues.
Obligee	(Also called "owner") the party to whom someone else is obligated under a contract; the party protected by the bond against loss; an obligee may be a person, firm, corporation, government, or an agency of a government.
Prime Contractor	Person with whom the obligee has contracted to perform the contract.
Principal	The one who is primarily responsible for fulfilling the obligation set forth on the contract and for whom the bond is issued. The principal is usually the contractor or subcontractor for whom SBA's surety bond guarantee is written.
Recovery	Reimbursement received by a surety from subrogation, indemnitors, or from salvage following a loss.

The Fidelity and Deposit Companies
Fidelity and Deposit Company of Maryland
Fidelity and Surety Department
P. O. Box 17171
Baltimore, MD 21297-1171
My Direct Line is: 410-528-4669

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OFFICE OF SURETY GUARANTEES

February 17, 1999

Mr. Robert J. Moffitt
Associate Administrator
Office of Surety Guarantees
U.S. Small Business Administration
409 3rd Street, N.W.
Suite 8600
Washington, D.C. 20416

Dear Bob:

Enclosed please find "Fidelity & Deposit Co. of Maryland's Comments on the U.S. Small Business Administration Office of Inspector General's February 2, 1999 Draft Report on Audit of Fidelity & Deposit Co. of Maryland, Baltimore, Maryland" and supporting documentation. Before addressing a few of the key substantive issues, I would like again to express F&D's appreciation for the courtesy and consideration shown by yourself and your colleagues in the SBA Office of Inspector General (OIG) during the course of this audit.

The Draft Report accurately described those items on which F&D has previously credited or agree to credit the SBA. Accordingly, F&D's comments are limited to those items on which F&D disagrees with the conclusions or recommendations of the SBA OIG and two additional items on which F&D now concurs with the SBA OIG's recommendations. F&D's comments are ordered to correspond with the order of the Draft Report. However, F&D's comments/response fall principally into one of three categories.

First, F&D has completed certain previously agreed factual inquiries and now concurs with the SBA's findings on two additional groups of bonds: The [FOIA ex. 4, 6] bonds (with respect to the pursuit of additional indemnitors) and the [FOIA ex. 4, 6] bonds. Specifically, F&D agrees to credit the SBA $21,350 on the [FOIA ex. 4, 6] bonds and $10,771 on the [FOIA ex. 4, 6] bonds.

Second, the factual predicates for two of the items in the Draft Report are incorrect. These specific grounds were articulated to F&D for the first time in the Draft Report. Accordingly, this is the first opportunity which F&D has had to respond to and explain these inaccuracies. As F&D's Comments make clear, once the facts are correctly understood, there is no basis for seeking recovery on either item. We urge that the SBA OIG review these items

Mr. Robert J. Moffitt
February 17, 1999
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carefully and delete them before issuing the final report. The two items at issue are [FOIA ex. 4, 6] Claim Number [FOIA ex. 2] (on which the SBA seeks to recover $1,004.50) and [FOIA ex. 4, 6] Claim Number [FOIA ex. 2] (on which the SBA seeks to recover $101,332). While we are concerned about the dollars at stake, we are also particularly concerned about the possibility of repeating the situation which we had last summer, where factually incorrect information was reported to the public. We are optimistic that once the facts are correctly understood, these items will be removed from the final report.

Third, there are three items on which F&D continues to disagree with the findings or recommendations made by the SBA OIG. The three items are [FOIA ex. 4, 6] With respect to [FOIA ex. 4] it appears that the SBA OIG is no longer relying on any of the three specific grounds previously asserted for denying liability (to which F&D has previously responded). Instead, the SBA OIG asserts a fourth and entirely new factual basis for seeking recovery. No documentation has been provided to F&D to support the assertion being made. Absent any supporting documentation, F&D continues to believe that this bond was eligible for guarantee and that the claim was proper for reimbursement.

In the event that the SBA OIG elects not to change its conclusions or recommendation with respect to any of the items disputed by F&D, F&D requests that opportunity to meet with you or the appropriate person in your office to appeal the SBA OIG's decision.

Please call me if you have any questions or would like to discuss these items further.

Very truly yours,

[FOIA ex. 6]

Kenneth M. Givens, Jr.
Vice President

nmf

Enclosure

Freedom of Information/Privacy Act Release
Redaction Marker

FOIA or PA Exemption(s)	FOIA Exemption 4
Withheld Pages	Pages 20 - 26
Description	Seven pages withheld in full pursuant to FOIA Exemption 4

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