Fidelity and Surety Law Alert
November 2014

Federal Regulations Amended to Allow Agencies to Decline to Accept Bonds from Treasury Listed Sureties “For Cause”, Providing Contracting Officers a New Cudgel

In a previous Alert we reported that the New York Supreme Court in Nassau County had ruled in our surety-client’s favor, rejecting a project owner’s attempt to circumvent the requirements set forth in the most commonly used performance bond – the AIA Document A312. The owner appealed from that decision and, on behalf of the surety, we argued the appeal on December 10, 2013. On July 2, 2014, the Appellate Division, Second Department issued its decision affirming the lower court’s ruling (Archstone v. Tocci Building Corporation of New Jersey, Inc., Liberty Mutual, et al., ___N.Y.S.2d___, 2014 WL 2958176 (N.Y.A.D. 2 Dept.))


Revised Section 223.17: “Acceptance and non-acceptance of bonds”

In order for a surety to obtain a certificate to issue federal surety bonds, it must satisfy the documentary, filing, and financial requirements set forth in Title 31, as further expanded and clarified by Part 223. Moreover, 31 U.S.C. § 9304(b) requires, in part, that “[e]ach surety bond shall be approved by the official of the Government required to approve or accept the bond.” Courts had previously interpreted this provision to grant officials the discretion to refuse to accept a surety bond.1 The Final Rule adds to Part 223 a new section, Section 223.17, which explicitly recognizes that an agency may, “for cause,” decline to accept a certified surety’s bond.2 While it may have been within an agency’s discretion to decline certain surety bonds in the past, Section 223.17 threatens to systematize the agency’s use and potential misuse of such discretion.

The agency must give advance written notice which (i) notifies the surety of the agency’s intention to decline the bond(s), (ii) sets out the agency’s reasons or cause for doing so, (iii) provides the surety with an opportunity to rebut the agency’s reasons or cause, and (iv) gives the surety an opportunity to cure the reasons or cause.3 After the Agency has considered the surety’s response, or if the surety fails to

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1 See, e.g., Concord Cas. & Sur. Co. v. United States, 69 F.2d 78 (2d Cir. 1934); Am. Druggists Ins. Co., Inc. v. Bogart, 707 F.2d 1229 (11th Cir. 1983).
2 31 C.F.R. 223.17(b) (effective Dec. 15, 2014).
3 Id. at § 223.17(b)(1).

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respond, the Agency may decline the surety’s bonds after issuing a written determination of non-acceptance.\(^4\)

The exact procedures and standards for this process will be agency-specific. Each agency must promulgate, by way of notice-and-comment rulemaking, regulations articulating each agency’s “procedures and for cause standards for declining to accept bonds”.\(^5\) What might therefore be considered “for cause” reasons justifying an agency’s declination of a surety’s bonds will be established separately by each agency. The Treasury has instructed that “for cause” includes but is not limited to “circumstances when a surety has not paid or satisfied an administratively final bond obligation due the agency.”\(^6\) In addition to defining additional “for cause” reasons, each agency must determine “when a bond obligation becomes administratively final under the agency’s procedures.”\(^7\) Lastly, while each agency must provide the surety with an opportunity to rebut the agency’s reasons or cause, as well as an opportunity to cure any such reason or cause, each agency will have to decide what, exactly, these opportunities will be.\(^8\)

Of the many concerns presented by the Final Rule, one is paramount: The new regulations appear to systematize and endorse an agency’s ability to unfairly leverage its bond claim, as a surety’s decision to contest such claim could form the basis for the declination of its bonds. Indeed, although the Treasury has instructed that “for cause” includes (but is not limited to) a surety’s failure to pay or satisfy an administratively final bond obligation, each agency will be able to promulgate both additional “for cause” reasons as well as an agency-specific definition of when a bond obligation becomes “administratively final.” This enables an agency to provide itself with “cause” for declining a surety’s bonds, even in the absence of an independent judicial determination of the surety’s bond obligations. For that matter, it also remains possible for an agency to include, as an additional “for cause” reason, the fact that a surety has not paid or satisfied another agency’s bond claim—thereby threatening the surety with loss of business on multiple fronts if it chooses to litigate what it considers to be good-faith bond defenses and is not willing to forego asserting them.

Sureties that do business with particular agencies, and representative entities such as the SFAA and AIA, should therefore stay abreast of future agency rulemaking and either participate or engage representatives to participate to the extent possible under each agency’s rulemaking procedures. Presumably, the SFAA and/or the AIA will play an active role in this process. Such efforts should seek, for instance, definitions of “for cause” and “administratively final” bond obligations that, taken together, may reduce the risk that a surety will face penalties for asserting good-faith defenses to bond claims. In addition, the surety’s opportunity to rebut and/or cure the agency’s reasons or causes should amount to more than minimal due process. At the very least, a surety should be entitled to place a deposit with the agency in order to stay the agency’s declination of future bonds pending a resolution of the unpaid bond claim at issue. Such deposit would either be repaid to the surety if the surety prevails or be applied towards any settlement or adverse adjudication with the agency.

If notified that an agency intends to decline its bonds, the surety’s response will need to be tailored to the procedures and standards adopted by that agency. However, it should be kept in mind that no agency has authority to decline bonds if the surety obtains a judicial order staying or enjoining either the underlying obligation or the agency’s written determination to decline the surety’s bonds.\(^9\) Therefore, in

\(^4\) Id. at § 223.17(b)(2).
\(^5\) Id. at § 223.17(b)(3). In certain circumstances, an agency’s preexisting rules or regulations may suffice for this purpose. See id.
\(^6\) Id.
\(^7\) Id.
\(^8\) See id.
\(^9\) See id. at § 223.17(b)(5)(i).
certain circumstances—particularly if the surety must protect immediate business opportunities—obtaining a restraining order may be necessary.\(^{10}\) Additionally, no agency may decline an otherwise acceptable payment and performance bond if it had already accepted a bid bond from the same surety for the same contract.\(^{11}\)

**Revised Section 220.20: “Revocation proceedings initiated by Treasury upon receipt of an agency complaint.”**

The Treasury’s Final Rule also adds to Part 223 new Sections 223.18, .19, and .20, which prescribe procedures for the revocation of a surety’s certification. Revocation may occur: (i) when the Treasury determines that a surety is not in compliance with standing and financial requirements set forth in 31 U.S.C. §§ 9304-08, or (ii) when an agency submits a complaint to the Treasury seeking the revocation of a surety’s certificate because the surety “has not promptly made full payment or fully satisfied one or more bond obligations naming the agency as obligee.”\(^{12}\)

The agency’s complaint must certify that: (1) the bond obligations are “administratively final under the agency’s regulations or other authorities,” (2) the surety has not paid the bond obligation, and (3) that the surety’s obligations to pay or satisfy the bond obligations have not been judicially stayed or enjoined.\(^{13}\) While the agency must also submit certain supporting documentation, it does not appear that it must initially document the full merits of the claim itself.\(^{14}\)

Following receipt of an agency complaint, the Treasury will notify the surety. Within 20 business days, the surety must “submit a written explanatory response,” and will be “afford[ed] . . . the opportunity to address the complaint and demonstrate its qualifications to retain its certificate of authority.”\(^ {15}\) The surety also can request an informal hearing at which it may be represented by counsel.\(^ {16}\) Following a review period, the Treasury will issue a written final decision either denying the agency’s complaint or revoking the surety’s certificate.\(^ {17}\) The standard guiding the Treasury’s decision is “whether the default is clear and whether the [surety’s] failure to pay or satisfy the bonds is based on inadequate grounds.”\(^ {18}\)

One of the primary concerns raised by this procedure is that by requiring the surety to respond to an agency complaint by “submit[ting] a written explanatory response” and “demonstrat[ing] its qualifications to retain its certificate of authority” and by not requiring the agency to make any initial showing as to the full merits of the claim itself, the burden of proof rests entirely with the surety. The procedures set forth in

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\(^{10}\) The surety seeking such relief would likely have to satisfy most or all of the following factors: (a) that the surety has a reasonable chance of success on the merits of either its defenses to the bond obligation(s) underlying the agency’s decision to decline the surety’s bonds, or its challenge to the agency’s decision, (b) that no adequate remedy at law exists and therefore, absent the relief sought, the surety will suffer irreparable harm as a result of the agency’s declination of its bonds, (c) that the equities favor restraining the agency’s declination of the surety’s bonds, and (d) that restraining the agency’s declination of the surety’s bonds is not harmful to the public interest. See, e.g., Peters v. Noonan, 871 F.Supp.2d 218, 224 (W.D.N.Y. 2012) (setting forth a four-pronged standard for party seeking imposition of temporary restraints).

\(^{11}\) 31 C.F.R. § 223.17(b)(5)(ii) (effective Dec. 15, 2014).

\(^{12}\) Id. at § 223.18.

\(^{13}\) Id. at § 223.20(a).

\(^{14}\) Id. at § 223.20(b).  

\(^{15}\) Id. at § 223.20(c).

\(^{16}\) Id. at § 223.20(h).

\(^{17}\) Id. at § 223.20(d) and (e).

\(^{18}\) Id. at § 223.20(h).

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Section 223.20, combined with a definition favorable to the agency of what constitutes an "administratively final" bond obligation under the agency's rules, could provide the agency with additional leverage in a dispute with a surety that asserts meritorious bond defenses.

Previously, a surety was afforded 20 business days to cure its alleged default following a Treasury decision to revoke the surety's certificate.\(^{19}\) This opportunity still exists under new Section 223.20, but will be denied to a surety whose non-compliance is "willful," which is defined as a "careless or reckless disregard of a known legal obligation to satisfy an administratively final bond obligation."\(^{20}\) Although Section 223.20(h) sets forth a list of factors to be considered in deciding whether non-compliance is "willful," this open-ended, non-conclusive list could allow the Treasury to premise a finding of "willful" noncompliance upon what a surety may consider to be its good-faith assertion of bond defenses. Therefore, sureties planning to dispute a federal bond claim must also be prepared to dispute allegations of "willful" non-compliance in order to preserve the 20-day cure period, which could be necessary to maintain future business opportunities.

Responding to an agency complaint under the new Section 223.20 will therefore require a considered legal strategy fitting this unique setting. It is foreseeable that a staple response may include seeking an appropriate restraining order or other similar relief, as the agency must certify in its complaint that the surety’s "obligation to pay or satisfy the bond obligation has not been stayed or enjoined by a court of competent jurisdiction."\(^{21}\)

Additionally, an agency’s decision to decline a surety’s bonds, or decision by the Treasury to revoke a surety’s certificate, are ostensibly subject to judicial review as a “final agency action” under the Administrative Procedure Act.\(^{22}\) This may even be the case regarding the agency’s underlying “administratively final” bond determination (that would, in part, depend upon the procedures and definitions the agency adopts in the future). However, assuming such jurisdiction is available, judicial review would likely be limited to the “arbitrary and capricious” standard often used to review agency action.\(^{23}\) Therefore, the availability of judicial review under the APA might not prove adequate to allay the concerns presented by new Sections 223.17 and .20.

Conclusion

The Treasury’s recent Final Rule regulating the declination of a surety’s bonds, as well as the revocation of a surety’s ability to issue federal bonds, may be subject to misuse by aggressive agencies seeking to coerce sureties to abandon good-faith defenses to agency bond claims. Sureties and surety industry representatives will be well-advised to take an active role in individual agencies’ rule-making. Each agency’s rules should ensure the availability of adequate procedural due process and judicial review regarding contested claims, so that sureties may cure any cause resulting in a final determination of

\(^{19}\) See former 31 C.F.R. 223.20 (to be superseded on Dec. 15, 2014).
\(^{21}\) See id. at § 223.20(a)(3).
\(^{22}\) See 5 U.S.C. § 704 (subjecting to judicial review “final agency action for which there is no other adequate remedy in a court”).
\(^{23}\) See Manin v. Nat’l Transp. Safety Bd., 627 F.3d 1239, 1241 (D.C. Cir. 2011) (revocation of various certificates held by pilot would be upheld “unless it is ‘arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.’”) (citing 5. U.S.C. § 706(2)(A)).
liability before the surety faces the draconian penalty of the non-acceptance of its bonds by that agency, or worse, the loss of its ability to issue any federal bonds.

For more information, please contact your Wolff & Samson PC attorney or the authors listed below.

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