

BASICS OF SURETYSHIP (151-1)

EO 1. **THE ROLE OF SURETYSHIP AND THE USE OF BONDS**--A **surety bond** is a written contract in which one party (**the surety**) guarantees that another party (**the principal**) will fulfill his obligations to a third party (**the obligee**).

The surety contract is *always* preceded by a legal obligation or a contract between the principal and obligee.

The execution of a bond creates an additional contract between the principal, the obligee, and the surety.

Although, in a surety bond, the surety guarantees the principal's performance of the original contract, the principal retains primary responsibility for the original contract.

If the principal defaults, the surety may *either* pay the bond penalty *or* make arrangements to complete the original contract.

The principal must indemnify the surety for any loss resulting from the default, *even if* that means the principal must undergo bankruptcy.

THE SURETYSHIP RELATIONSHIP is a three-party relationship:

1. **The principal** has the primary responsibility for fulfilling the underlying obligation and must either perform or pay money damages.
2. **The obligee** is the bond's beneficiary and the party to whom the principal owes performance. If the principal does *not* fulfill his obligation(s), *both* the principal *and* the surety are liable to the obligee.
3. **The surety** guarantees the principal's performance, but the surety's liability to the obligee is limited to the amount of the bond.
In the event of default, the surety fulfills the terms of the principal's contract and is entitled to indemnification from the principal and any remaining payment due from the obligee.

Suretyship involves **joint and several liability**.

The obligee may seek recovery from the principal, the surety, or both.

Both the principal and the surety are *individually* liable for the *entire* obligation, *but* the surety has a right to reimbursement from the principal.

A bond remains in effect for the duration of the underlying agreement and can *not* be cancelled by the surety--*even if the principal fails to pay the premium!*

A surety contract is an **indemnity agreement** (contract under which one party agrees to reimburse a second party for losses the second party must pay).

The statute of frauds requires that certain contracts (such as guarantees of debt or obligations of another, ie, surety bonds) *must* be in writing and signed by the parties.

Any changes to the surety contract must also be signed and in writing.

A **typical surety bond** indemnifies the obligee for his actual loss up to the **bond penalty** (limit of liability).

A **forfeiture bond** provides for immediate payment of the entire bond penalty regardless of the extent of the obligee's loss.

The two basic types of bonds:

1. **Contract surety bonds**--guarantee that their contractor-principals will perform all obligations under their bonded construction contracts.
2. **Commercial (noncontract) surety bonds**--guarantee the performance of obligations that do *not* arise from contracts.

[Fidelity bonds were a type of surety bond that guaranteed employee honesty.

Fidelity bonds have been replaced by employee dishonesty insurance.]

EO 2. **BONDS REQUIRED BY LAW:**

1. **Performance bonds**--guarantee performance of their underlying contracts.
In the event of default, the obligee will be indemnified for any loss resulting from the contractor's failure to perform his promise according to the plans, contract, and specifications.
2. **Payment bonds**--guarantee that the principals/contractors will fully pay for all project labor and materials by the completion of the projects (so the completed projects will be free of any liens).
3. **Public official bonds**--guarantee that public officials will faithfully discharge their statutory duties and keep their oaths of office to the best of their abilities.
4. **Fiduciary bonds**--guarantee the honest and faithful performances of the persons appointed by the courts to handle the property or interests of others.
5. **License and permit bonds**--guarantee performance of obligations required by licenses or permits.
6. **Blanket fidelity bonds**--cover employees of state and local governments.

EO 3. **THIRD-PARTY BENEFICIARIES IN SURETYSHIP**--Third-party beneficiaries are *not* parties to the contract or bond, but benefit from its existence.

Examples:

1. **The labor and materials bond on a public construction project**--Unpaid subcontractors, laborers, and suppliers of public works contractors have *no* right to mechanics liens against public property *or* to collect from the public body.
A labor and materials bond assures they will be paid.
2. **A public official bond**--A person injured by an act of a public official can proceed against the official and against the surety on the official's bond.
3. **A fiduciary bond**--A fiduciary bond protects innocent third parties from loss by misappropriation of funds by fiduciaries, such as trustees, executors, administrators, and guardians.

EO 4. **REASONS FOR THE DECLINE OF PERSONAL SURETYSHIP**--Most people became personal sureties as a favor to friends and relatives. Default by the principal created animosity. The surety himself often did not have sufficient funds to pay the obligation and the obligee was not able to recover from the principal or surety.
Also, the law favored personal sureties.

CORPORATE SURETYSHIP developed as the American economy became more complex and the amounts of money involved became too large for personal sureties.

EO 5. **SURETYSHIP AND INSURANCE** have similar financial procedures, reporting procedures, and legal and underwriting characteristics.
Consolidation of suretyship and insurance into one corporation enhances that company's financial credibility and broadens its potential market.

EO 6. **THE ROLES PERFORMED BY SURETY PERSONNEL:**

1. **PRODUCERS** sell insurance and surety products.
A producer's authority to execute bonds is limited either by the terms of a **power of attorney** (instrument authorizing the producer to act as the surety's agent) or another agreement between the producer and surety.
The producer must act as the surety's agent.
2. **UNDERWRITERS** assess the data provided, decide whether to approve the bond, determine the appropriate premium, dictate any conditions the applicant must meet, determine who should indemnify the surety, *and* decide whether to require collateral.
3. **CLAIM REPRESENTATIVES** determine and evaluate the facts, review the law and apply it to the facts, *and* document their decisions and actions.

The National Association of Surety Bond Producers (NASBP) is the organization of independent insurance producers that educates the public, legislators, and contractors about the benefits of surety bonds.

The National Association of Independent Sureties (NAIS) is the nonprofit entity that provides educational programs for surety underwriters.

The Surety Association of America (SAA) collects premium and loss data for fidelity and surety bonds and calculates loss costs for its member companies.

EO 7. **SURETYSHIP VS. INSURANCE:**

1. **Common features--Both insurance and suretyship involve**

- a. assumption of risk by a professional risk-taker,
- b. payment of a premium,
- c. protection against financial loss, *and*
- d. a contractually-defined risk.

2. **Distinctive characteristics--**

- a. **Insurance**--protects the insured against the financial consequences of loss. *Insurers expect losses* and pool the losses of group members.
- b. **Suretyship**--protects the obligee from exposures to loss by prequalifying prospective principals.
In suretyship, the risk of default stays with the principal because he must reimburse the surety for any payments made on his behalf.
The surety expects no loss.

SURETYSHIP VS. BANKING:

1. **Common features**--Suretyship is similar to an extension of credit by the surety to the principal. **All parties in a suretyship** expect performance of the obligation, do *not* expect to suffer losses, *and* acknowledge the right to restitution upon default.
2. **Distinctive characteristics**--Suretyship guarantees *both* performance *and* monetary obligations.

EO 8. **THREE UNDERWRITING CONSIDERATIONS IN SURETYSHIP:**

1. **The nature of the contractual obligation**--Exposures vary based on the underlying obligations. Bonds with a low loss frequencies and small face amounts require little underwriting and are more freely written.
Bonds with highly speculative obligations may not be written at all--even for the best applicants. Instead, the surety may encourage the principal to change the nature of the obligation.
2. **The principal's ability to perform**--Because the principal always remains bound to his obligations under the original contract, the surety should investigate the principal's financial capacity, past experience, and any resources other than money needed to fulfill the obligation.
3. **The nature of the principal's performance**--Bond obligations that provide for performance to specifications and plans are less risky than obligations that are ambiguous or subjective regarding performance or results.

EO 9. **THE PRINCIPAL'S GUARANTEE TO THE SURETY:**

1. **Indemnity agreements**--Sureties require indemnity from *all* bond applicants.
The principal agrees to reimburse the surety if the surety pays upon the principal's default. If the applicant is not an individual, the surety may require indemnity agreements from those with financial interests in the entity.
An indemnity agreement states that, in the event of a claim on the bond, the surety may require cash collateral, take control of the project, *or* collect the balance of the contract funds. Under a **general indemnity agreement** (or general application for a bond), the applicant becomes the surety's indemnitor on all bonds executed on behalf of any principal named in the agreement.

2. **Collateral**--If a surety decides to write a risky bond, the surety should require the principal to post adequate **collateral** (something of value used to secure an obligation). Collateral for a surety bond is usually cash or **liquid assets** (property that can be easily converted into cash).
3. **Security interests in property**--A **security interest** is a property interest that lets the property be sold to satisfy an underlying debt.
Property (anything capable of being owned) **includes real property** (land and its permanent attachments) **and personal property** (property other than real property).
 Although security interests in tangible personal property or real estate are valuable, they are **not** easily converted to cash.
 A surety who uses an interest in property as collateral must file the security agreement in the proper court to **perfect the security interest** (give the surety priority over other creditors with an interest in the property).
 Sureties and principals use **collateral agreement forms** to specify the conditions for **posting** (providing) and returning the collateral.

EO 10. **THE LEGAL AND EQUITABLE REMEDIES AVAILABLE TO A SURETY:**

1. **Indemnification**--The principal must repay the surety for any loss resulting from the surety's payment on behalf of the principal.
2. **Exoneration**--The surety may compel the principal to perform once the surety receives notice of the principal's default.
3. **Subrogation**--Once the surety pays the third party, the surety obtains the right to enforce the third party's rights against the principal.
- [4. **Quia timet**--*The surety may sue the principal to prevent any loss if the surety has reason to believe the principal will default. (See Assignment 9.)*

A **legal remedy** is a court-ordered award of monetary damages to an injured party.

An **equitable remedy** is a court-ordered solution based on principles of fairness.

EO 11. **TO IDENTIFY THE ROLE OF SURETYSHIP IN A GIVEN SITUATION**, apply what you learned in this assignment.

EO 12. **SUBCONTRACTOR DEFAULT INSURANCE** is a two-party contract in which the insurer agrees to indemnify the insured (contractor) for costs incurred as the result of a subcontractor's performance default.

Five ways a contractor can minimize risk on a construction project:

1. Qualify the owner.
2. Screen subcontractors [*commonly called 'subs'*].
3. Require clear, complete subcontractor agreements.
4. Monitor contracts.
5. Require performance and payment bonds from subcontractors.

Six factors underwriters consider when prequalifying subcontractors:

1. Financial strength and credit rating.
2. Experience and reputation.
3. Exposure and work-in-progress on other contracts.
4. Ability to perform the work.
5. Subcontractor agreements.
6. Size and location of work.

TRADITIONAL SURETY BONDS VS. TRADITIONAL INSURANCE:

1. **Regulation**--Both surety bonds and insurance are regulated by state insurance departments.
2. **Parties**--Suretyship is a three-party agreement that protects the obligee.
Insurance is a two-party agreement that protects the insured.
3. **Premiums**--Bond premiums are based on the contract price.
Insurance premiums are actuarially determined.
4. **Coverage**--Bond coverage is project-specific.
Insurance coverage is term-specific.
5. **Forms**--Bond forms are standardized, but may be negotiated.
Insurance forms vary by insurance company.
6. **Claims**--The surety has the right to the contract balance.
The insurer has *no* right to the insured's assets.

PERFORMANCE AND PAYMENT BONDS VS. SUBCONTRACTOR DEFAULT INSURANCE:

1. **Prequalification**--The surety prequalifies subcontractors under the bond.
With insurance, the contractor must evaluate the subcontractors.
2. **Structure**--Suretyship is a three-party agreement.
Insurance is a two-party agreement.
3. **Payment protection**--Subcontractors and suppliers are guaranteed payment by the payment bond, but they can *not* make a direct claim with the insurer under a subcontractor default policy.
4. **Default management**--A bond surety investigates the legitimacy of claims and arranges for contract completion.
An insured contractor has unilateral power to declare default and replace subcontractors and is responsible for completing the contract and filing a claim with the insurer.
5. **Risk**--A surety assumes the risk of contract completion and payment to subcontractors and suppliers.
An insured contractor retains some risk through deductibles and copayments.
6. **Legal issues**--Suretyship is required by law on public projects; default insurance is not.
Suretyship has a long history of case law and legal precedent; default insurance does not.

Unasked EO. **TWO WAYS SURETIES TRANSFER AND SHARE EXCESSIVE RISKS:**

1. **Reinsurance**--is a contractual agreement under which one insurer (the **primary insurer**) transfers to another insurer (the **reinsurer**) all or part of the risks that it has assumed under primary insurance contracts.
2. **Cosureties**--are two or more sureties who join together to issue a single bond and share the exposure.
The cosureties and the principal are jointly and severally liability to the obligee.

THE TWO BASIC TYPES OF REINSURANCE:

1. **Facultative reinsurance**--has the reinsurer underwrite each risk individually.
2. **Treaty reinsurance**--underwrites an entire line or book of business.
The reinsurer accepts some or all of *every* risk in the class or portfolio.