

COMMERCIAL SURETYSHIP (153-1)

EO 1. 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, 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.

TWO MAJOR CATEGORIES OF COMMERCIAL BONDS:

1. **FIDELITY BONDS** indemnify employers for losses caused by dishonest acts of covered employees up to their bond **penalties** (limits).
Employers buy fidelity bonds for their own benefit.
2. **SURETY BONDS** provide compensation from sureties for principals' failures to perform specified acts within specified periods. They are bought by principals for their obligees' benefit and may cover dishonest acts by principals and their employees.

EO 2. THE FOUR TYPES OF COMMERCIAL SURETY BONDS:

1. **License and permit bonds**--guarantee performance of obligations required by a license or permit.
Examples: compliance guarantees for electricians and plumbers, license bonds for real estate brokers and car dealers, and bonds required hazardous for activities such as fireworks or blasting.
2. **Public official bonds**--guarantee honest and faithful performance of official duties including receiving and accounting for money and property handled by the principal's office.
Examples: bonds for tax collectors, assessors, insurance commissioners, judges, and sheriffs.
3. **Court bonds in civil proceedings--include three major categories of bonds:**
 - a. **Judicial bonds**--arise out of litigation and are posted by persons seeking or appealing court remedies to guarantee the payment of money required by courts' final verdicts.
Example: appeal bonds.
 - b. **Admiralty bonds**--pertain to legal situations involving waterways and seas.
Example: bonds required of shipowners to protect cargo.
 - c. **Fiduciary bonds**--guarantee the honest and faithful performances of the persons appointed by the courts to handle the assets or affairs of others.
Examples: bonds required of executors, guardians, and bankruptcy trustees.
4. **Miscellaneous surety bonds**--do not fit within the other categories because they typically involve private relationships and/or unique business needs.
Examples: lost securities bonds and hazardous waste removal bonds.

EO 3. PRODUCTION ISSUES RELATED TO COMMERCIAL SURETY BONDS:

1. **Two roles of producers--Producers**
 - a. help bond applicants complete applications and indemnity agreements *and*
 - b. use sureties' powers of attorney and underwriting authority to execute bonds.
2. **Four common characteristics of commercial surety bond producers--A successful producer**
 - a. knows the products and services,
 - b. has effective contact with customers to show that knowledge,
 - c. can convince customers that the producer's firm best meets their needs, *and*
 - d. has power of attorney and underwriting authority from sureties.

3. **Six sources of commercial bond business:**
 - a. Business associations.
 - b. Banks and other financial institutions.
 - c. Political organizations.
 - d. Arrangements with other producers.
 - e. Requests for referrals from existing customers.
 - f. Attention to legislation that requires new bonds.
4. **Two forms of producer marketing:**
 - a. **Mass marketing**--involves the development of specialized bond programs for bonds the producer writes frequently.
Mass marketing is heavily dependent on computers for soliciting customers, marketing and issuing bonds, *and* preparing business reports.
 - b. **Niche sureties**--adapt bond products to meet the needs of small market segments.

EO 4. **UNDERWRITING COMMERCIAL SURETY BONDS:**

1. **Three questions surety underwriters must answer:**
 - a. What is the extent of the principal's obligation?
 - b. What terms or conditions should the surety require before it guarantees the principal's performance?
 - c. Based on **the three Cs** (character, capacity, and capital), is the applicant unlikely to default on the obligation?

Underwriters examine the bond application, the bond form, the laws that require the bond, and other documentation and then investigate any concerns.
2. **Six characteristics of commercial surety bonds:**
 - a. The principal has the primary responsibility for fulfilling the underlying obligation. In the event of default, the principal must **indemnify** (reimburse) the surety for the amount the surety paid to fulfill the obligation.
 - b. The surety expects *no* losses.
 - c. Bonds are for indeterminate periods and are noncancelable.
 - d. **A surety bond can be**
 - a. **statutory** (required and regulated by law) *or*
 - b. **nonstatutory** (controlled by the obligee's contract).
 - e. The surety tries to limit its obligation to the amount of the **bond penalty** (the bond amount that states the limit of liability).
 - f. Courts can extend the surety's obligation to additional parties.

SIX COMMON UNDERWRITING CONSIDERATIONS:

1. **Cancelability**--Some bond obligations are *not* cancelable within their terms.
Example: Lost instrument bonds are generally indefinite.
The underwriting problem arises because the surety is unable to cancel the bond if operational or economic changes make the risk unacceptable.
2. **Bond terms**--The term of the bond depends on the type of obligation and the obligee's requirements.
 - a. **Noncancelable (open term) bond**--remains effective indefinitely until the underlying obligation has been met.
 - b. **Renewable term bond**--is written for a specified term, but may be extended by attaching a **continuation certificate**.
 - c. **Continuous term bond**--remains in force until cancelled.
 - d. **Definite term bond**--is written for a year or specified number of years and must be replaced by a new bond at the end of its bond term.

3. **Cumulative liability**--Cumulative liability is the aggregate amount recoverable under two or more bonds on behalf of the same principal filed in succession, but where the succeeding bonds don't extinguish liabilities under their previous bonds.
Examples: some used car dealer bonds and continuous customs bonds.
 Cumulative liability may also arise when the bond penalty is assessed per incident or claim without regard to the maximum exposure.
A loss cap lets the surety set a maximum amount of liability on a bond.
 Sureties can *not* set loss caps on statutory bonds.
4. **Lawyers' fees**--Some bonds pay their obligees' legal fees relating to bond claims.
 Usually, coverage is limited to the combined amount of the claim and fees up to the penal sum or bond penalty.
 Sureties should determine if bond-related statutes cap attorneys' fees.
5. **Third-party suits--Third-party liability** is the public's legal right (*not* the obligee's right) to sue individually for damages resulting from the licensee's breach of obligations under the law that required the bond.
 States often give their citizens a direct right to file claims on license and permit bonds.
 Sureties may face claims and expenses from many claimants. Aggregate losses could exceed the bond penalty and create problems regarding distribution of the bond penalty.
6. **Moral hazard**--There is a risk of embezzlement when a person is entrusted with another's funds.
 Sureties should impose safeguards (such as annual audits) to prevent losses.

COMMERCIAL SURETY UNDERWRITING FORMS:

1. **Application**--collects information for a single bond.
Sureties use *either*
 - a. a unique application for each class of bond *or*
 - b. one all-purpose application with a section for basic information and separate sections for specific classes of bonds.

Three sections of a bond application:

- a. **Applicant's qualifications**--gives surety underwriters information about the applicant's background, qualifications, experience, *and* ability to manage funds.
 - b. **Indemnity language**--describes the principal's duties that protect the surety and gives the surety a right of action against the principal in the event of loss.
 - c. **Collateral agreement**--indicates that the principal has pledged **collateral** (cash or near cash assets that secure the obligation) to protect the surety against financial loss from default.
Common types of collateral include letters of credit (bank instruments that authorize the surety to withdraw up to a specified amount from the principal's account), cash, certificates of deposit, *and* savings passbooks.
2. **Indemnity agreement**--is a contract under which the indemnitor (the principal) agrees to reimburse the indemnitee (the surety) for losses incurred by the indemnitee.
An indemnity agreement might be used instead of an application when
 - a. one principal (or several related principals) require more than one bond *or*
 - b. the bond obligation is large and/or complicated.

EIGHT BOND UNDERWRITING FACTORS:

1. **Experience**--Underwriters are more cautious with applicants who have little or no experience.
2. **Bond penalty**--Underwriters are more likely to require collateral as bond penalties increase.
3. **Financial strength**--Underwriters review financial statements to see that the applicant has the liquidity and capital to maintain business operations.
 Entities with significant debt and/or little capital are poor bond risks.

4. **Credit reports**--Underwriters request business and personal credit reports for larger and/or longer-term bond obligations.
Negative information in a credit report could cause the underwriter to decline a bond.
5. **Collateral**--Bonds with a higher-than-average risk of default may require collateral.
The underwriter should decline the bond if default is certain.
6. **Relevant insurance coverage**--If a bond includes hold-harmless or third-party liability provisions, the underwriter must require that the principal carry property and casualty insurance.
7. **Accommodation underwriting**--Occasionally, a surety underwriter might accept an otherwise unacceptable risk as an accommodation for a producer who provides other profitable business.
The surety can require collateral as protection against default.
8. **Adverse selection**--In some situations bonds are required only from those applicants that are most likely to default on the underlying obligation.
Sureties generally require full collateral as a condition of writing such bonds.

EO 5. **BOND RATING**--The bond premium includes the producer's commission, underwriting and administrative expenses, allowances for losses and loss-related expenses, *and* a profit factor.

1. **Eight rating factors in setting bond premiums--In addition to the underwriting considerations, sureties also consider**
 - a. the amount of credit,
 - b. hazards related to the obligation,
 - c. previous loss experience,
 - d. the potential exposure to loss,
 - e. the prequalification needed to underwrite the principal,
 - f. fluctuating economic conditions, *and*
 - g. regulatory controls.
2. **Loss costs**--The Surety Association of America (**SAA**) collects premium and statistical bond loss data and calculates **loss costs** (advisory rates based on loss experience).
Many SAA members use loss costs as the bases for their bond rates and develop multipliers that are applied to loss costs to determine the final rate for each class of bond.
A surety's actuary calculates its multiplier based on the surety's **expense load** (business costs specific to the surety, including its commissions, taxes, allocated expenses, reinsurance costs, desired profit, and contingency amounts).
3. **Rate regulation**--The SAA files loss costs with all states' regulatory agencies.
Sureties file their expense loads or independent rates only in the states where they are licensed.
Sureties must also file rates for any special rating plans, such as credits and bulk rates.
The four categories of procedures for rate filing:
 - a. **Prior approval**--Most states require prior approval of rates before they can be used.
 - b. **File and use**--Some states only require that rates are filed before they are used.
 - c. **Use and file**--A few states permit use of rates before they are filed.
 - d. **No filing required**--A few states use the open competition method that allows sureties to use any rate *if* the regulator is satisfied that it is **reasonable, adequate, and not unfairly discriminatory**. [*Know those three requirements.*]
4. **Special rating plans**--Many sureties file rating plans that give them the flexibility to respond to factors unique to a particular case.
Two categories of special rating plans:
 - a. **General filings**--include **credits** (premium reductions that reward favorable business practices) and **debits** (premium increases for bonds with higher risk) that the surety can apply to base premiums.
Credits and debits assign a predetermined percentage to each rating factor.
The total of credits or debits can *not* exceed a specified amount.

b. **Individual bond rate filings--**

- 1) **Business associations**--If a producer develops a marketing program targeted to a business association, the surety files a lower rate for the specific bonds used by group members.
- 2) **Producer generated business**--A surety might collaborate with a producer who solicits a specific type of bond, such as a low-risk license and permit bond. The surety can offer a reduced premium that reflects the increased bond volume and the expedited paperwork.

EO 6. **THE TEN STEPS IN COMMERCIAL SURETY BOND LOSS ADJUSTMENT:**

1. Identify the obligation that was allegedly breached.
2. Review the claimant's evidence.
3. Verify the claimant's allegations and evidence.
4. Identify sources of recovery through indemnity and subrogation.
5. Evaluate the situation.
6. Decide the company's position on the claim.
7. Set a loss reserve.
8. **Based on the company's position,**
 - a. pay the claim in full *or*
 - b. negotiate a settlement *or*
 - c. tender payment of the amount owed *or*
 - d. deny the claim and prepare to litigate.
9. Complete internal and external loss reporting in compliance with the surety's and reinsurer's guidelines and any regulations.
10. **Seek recovery for losses and expenses, by pursuing**
 - a. **salvage**--recovery through indemnification by the principal and any other indemnitors,
 - b. **subrogation**--recovery from third parties who bear some responsibility for the loss,
 - c. **exoneration**--the surety's right to require the principal to perform or post collateral when loss is imminent, *and/or*
 - d. **quia timet** (Latin for 'he who fears')--a court order that lets the surety attach the principal's assets, thereby preventing the principal from disposing of assets.

EO 7. **LEGISLATIVE ISSUES RELATED TO SURETY BONDS**--Legislators and regulators often set bond requirements without determining if sureties are willing to write the bonds. The SAA and other interested parties attend and testify at legislative and regulatory hearings on bond issues, thus educating regulators about potential problems and needs.

EO 8. **TO EXPLAIN BOND PRODUCTION, UNDERWRITING, RATING, AND CLAIMS HANDLING,** apply what you learned in EOs 1 - 7.