Overview of Suretyship

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SURETY BOND BASICS

Risk managers, producers, and other insurance and finance professionals who understand the role of suretyship as a risk-transfer mechanism can recommend or provide broad loss protection for their clients.

Suretyship offers a means of handling some loss exposures. Government entities, businesses, and individuals can transfer risk by requiring or requesting surety bonds from parties who owe them for certain types of obligations.

Suretyship refers to the relationship among the three parties to a surety bond. A definition of surety bonds, a review of various bond guarantees, and an explanation of two bond characteristics—statutory or nonstatutory—provide a foundation for professionals in understanding the operation and use of bonds as a risk-transfer mechanism.

Surety Bonds and Their Guarantees

A **surety bond** is a written document in which one party guarantees a second party's performance to a third party for the second party's failure to fulfill an obligation. The three parties to a surety bond are the principal, the obligee, and the surety. The **principal** is the bonded person or organization that has the duty to perform in some way for the benefit of the **obligee**. The **surety** is the party that guarantees fulfillment of the principal's obligation to the obligee. The surety bond protects the obligee by guaranteeing performance to the obligee if the principal does not fulfill the obligation.

Contract surety bonds guarantee the performance of certain public and private construction contracts. In a typical contract bond arrangement, a project owner (obligee) wants to build a structure or improve land. The project owner requires a construction contract bond to guarantee that the contractor will perform all obligations under the contract on time, within budget, and according to specifications. If the contractor defaults, the surety guarantees performance of the contract or pays (indemnifies) the obligee for all losses.

Commercial surety bonds, or noncontract bonds, involve all other situations in which sureties guarantee performance of obligations that generally do not arise from contracts. This is a diverse group of bonds, such as plumbers' license bonds and bonds for executors of wills that guarantee that duties will be performed honestly and as expected, as well as financial guarantee bonds for the

Surety bond

A written contract that expresses one party's promise to answer for another party's failure to do something as promised.

Principal

The party to a surety bond whose obligation or performance the surety guarantees.

Obligee

The party to a surety bond that receives the surety's guarantee that the principal will fulfill an obligation or perform as promised.

Surety

The party (usually an insurer) to a surety bond that guarantees to the obligee that the principal will fulfill an obligation or perform as required by the underlying contract, permit, or law.

Contract surety bonds

A classification of bonds that guarantee the performance of the bonded contractor.

Commercial surety bonds

Bonds that guarantee the performance of all obligations that do not arise from contracts.

payment of workers compensation. Each type of bond specifies the guarantee that is provided.

Fidelity bonds

Bonds that historically have guaranteed the honesty of employees. Fidelity bonds have been replaced by employee dishonesty coverage (insurance).

One class of surety bonds, **fidelity bonds**, traditionally guaranteed employee honesty. ("Fidelity" refers to employee honesty.) Today, employers are typically protected from loss by employee theft (or employee dishonesty) through a coverage form or a policy that covers several crime perils as well.

Surety bonds can be characterized as either statutory or nonstatutory. See the exhibit "Transferring Risk Through Surety Bonds."

Transferring Risk Through Surety Bonds

In insurance, risk is the possibility of financial loss. Governments, businesses, and individuals can protect themselves from financial loss by transferring their financial risk to sureties using surety bonds in many situations, such as these:

- A trustee negligently invests estate assets belonging to an incompetent person.
- A construction contractor fails to finish a project because its bid was inadequate to fund the project or pay the obligations resulting from the contract's performance.
- A public official fails to secure a public fund, and the money is stolen.
- The federal government loses revenue when importers fail to pay duties, fines, and penalties.

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Performance bond

A contract bond guaranteeing that a contractor's work will be completed according to plans and specifications.

Payment bond

A contract bond guaranteeing that the project will be free of liens.

Public official bond

A commercial surety bond guaranteeing that a public official will perform his or her duties faithfully and honestly.

Fiduciary bond

A court bond guaranteeing that a person appointed by a court to administer the property or interests of others will faithfully perform his or her duties.

Statutory Bonds

The obligation of a statutory bond is prescribed by a municipal ordinance or a federal or state regulation or statute (written law). Because the laws specify the conditions of a statutory bond, the obligations of all three parties are dictated by the applicable law and not by the bond provisions. Federal, state, and local governments and courts have required crime insurance (fidelity bonds) and surety bonds through statutes, regulations, ordinances, and court rulings. For example, to protect public funds, legislatures have enacted laws stipulating these requirements:

- Contractors entering into contracts with governmental agencies for improvements to real property must post two surety bonds: performance bonds and labor and material payment bonds. A **performance bond** guarantees performance of the contract. A **payment bond** guarantees payment of certain obligations incurred in the performance of the contract.
- To qualify for office, a public official must post a **public official bond** to guarantee faithful performance of his or her duties.
- Fiduciaries are people or legal entities that hold positions of trust, and courts appoint them to administer funds for others. A fiduciary must post a **fiduciary bond** to guarantee faithful performance of his or her duties.

- To qualify for licenses or permits, businesses or individuals must post **license and permit bonds** that guarantee their performance of obligations required by the licenses or permits.
- State and local governments require bonding of their employees under blanket fidelity bonds.

License and permit bonds
Surety bonds that provide payment to the obligee (the state, city, or other public entity) for loss or damage resulting from violations of the duties and obligations imposed on the licensee or permit holder.

Nonstatutory Bonds

As with governmental entities, the private sector—including business entities and individuals—requires many different types of surety bonds for protection from loss. The obligation of a nonstatutory bond is dictated by a contract between the principal and the obligee and by the bond provisions.

Although governments use contract surety bonds more extensively, the private sector also uses construction project bonds. Some private property owners require bonds from contractors, and general contractors require bonds from subcontractors in private construction work. Despite the protection offered by a contract surety bond, many in the private sector forgo a bond arrangement because they believe that a performance guarantee is not needed for a contractor that qualifies for a surety bond.

The private sector also uses financial guarantee bonds. Some examples are lease bonds, which guarantee the payment of rent by the lessee, and lost instrument bonds, which enable people to replace lost stock or bond certificates.

PERSONAL SURETYSHIP AND CORPORATE SURETYSHIP

Although the surety bonding business in the United States has for many years been conducted exclusively as corporate suretyship, knowledge of how the current surety business grew out of personal suretyship helps surety bond professionals to understand their business.

Personal suretyship developed under English common law and was involved in the development of the British Statute of Frauds. In the United States, following the Civil War, commercial growth and complex contracts led to the need for corporate suretyship, and surety companies emerged to join insurance companies that capitalized on the profitable surety bond business. The complementary nature of insurance and suretyship prompts multiline insurers to serve the growing market for surety bonds.

Personal Suretyship

Personal suretyship among private individuals is an age-old practice, but its use has diminished considerably. As the law of suretyship developed over the years, courts and legislatures sought to protect private individuals who became sureties for others without compensation, making it more difficult for obligees to collect funds to which they were entitled under bonds.

Common Law and Statutory Law

Common law (case law)

Laws that develop out of court decisions in particular cases and establish precedents for future cases.

Statutory law

The formal laws, or statutes, enacted by federal, state, or local legislative bodies.

The U.S. has both **common law (case law)** and **statutory law**. English common law (case law) was the foundation for American common law. The U.S. created its own common law after it became independent from England. The common law is important in decisions regarding suretyship and governs many suretyship issues today. In contrast with the common law, statutory law is written law created by legislative bodies.

Statutes of Frauds

In 1677, the English Parliament passed the Statute of Frauds to eliminate abuses in the enforceability of verbal contracts arising from acts of fraud and perjury. The Statute of Frauds required that, to be enforceable, certain contracts must be in writing and signed by the persons making the contract. Among the contracts covered by the statute was any promise to answer for another person's debts or defaults. Sureties do just that; they promise to answer for another person's (the principal's) debts. Most American states have adopted statutes similar to the original English Statute of Frauds.

Because bonds are sureties' promises to answer to obligees for principals' debts or defaults, statutes of frauds require that surety bonds be in writing and that sureties sign the bonds. Likewise, written memoranda, addenda, or riders attached to the bonds and signed by the sureties must support any changes in surety contracts.

Legal Treatment of Personal Sureties

Court decisions and statutes have developed common law that is favorable to individual sureties. Most statutes permitting personal sureties on bonds require that appropriate authorities carefully evaluate an individual's qualifications for suretyship. These evaluations provide protection for obligees.

Typically, an individual must establish a net worth in real estate either equal to twice the penal sum of the bond or in an amount otherwise acceptable to the obligee. The penal sum is the maximum amount a surety must pay under a bond if a principal does not fulfill an obligation.

Decline of Personal Suretyship

Historically, individuals often became personal sureties to help friends or relatives, and they did so without compensation. Defaults of principals in these situations were costly monetarily and interpersonally, often creating bitter enemies of friends and relatives.

Society could not continue to bear the costs of personal suretyship because it was often unreliable, leaving creditors with no recourse. Personal sureties,