Commercial Surety Overview

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COMMERCIAL SURETY BOND CATEGORIES

A discussion of commercial surety bond categories lays the groundwork for a broader understanding of commercial surety by indicating the range of protections surety bonds provide.

Commercial surety bonds can be divided into the following four basic categories:

- License and permit bonds
- Public official bonds
- Court bonds (judicial, admiralty, and fiduciary bonds)
- Miscellaneous surety bonds

License and Permit Bonds

License bonds and permit bonds are usually described together because of similarities between them. Federal, state, county, and municipal laws require that parties obtain licenses and license bonds for many occupations or professions. These laws specify the necessary bonds and the standard of conduct required of the bonded party. Other laws require permits before a business can perform special functions that are incidental to business operations, and these laws might require businesses to post permit bonds. For example, a contractor that uses explosives in a demolition project must obtain an explosives permit and bond. The bond guarantees that the contractor will pay for or repair any adjacent properties damaged by the explosion and will pay damages to any individuals who suffer bodily injury as a result of the operation.

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.

The primary function of license and permit bonds is to protect the general public and government bodies from financial losses incurred if the principal fails to fulfill its obligations. This protection applies to issues ranging from health and safety, to financial loss, to payment of taxes. In addition, these bonds help enforce standards of conduct for businesspersons or professionals.

Public Official Bonds

Public officials are elected, appointed, or hired to fulfill governmental functions. Federal, state, county, and municipal laws require these officials to post public official bonds before they assume their duties. **Public official bonds** guarantee that the principal will faithfully perform all official duties. These

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

duties include receiving, collecting, and properly accounting for all public funds and property handled by that office. Public officials are liable for acts or omissions of any deputies or subordinates they supervise. If the principal fails to meet its obligations, the surety must pay damages up to the bond penalty. The official is solely responsible to repay the surety for the loss and to pay any amounts that the bond does not cover.

Federal officials must post federal official bonds. For example, people who operate post offices from within other businesses, such as stores, must obtain Federal Post Office bonds.

Court Bonds

Court bonds

A classification of surety bonds guaranteeing that a person or an organization will faithfully perform certain duties prescribed by law or by a court or will demonstrate financial responsibility for the benefit of another until the final outcome of a court's decision.

Court bonds in civil proceedings include the following three major categories of bonds:

- Judicial bonds
- Admiralty bonds
- Fiduciary bonds

Judicial bonds enable participants in lawsuits to pursue remedies in the courts. Plaintiffs and sometimes defendants must post judicial bonds in civil lawsuits. Laws and court rules or practices specify the required judicial bonds. For example, a court might allow a party to a lawsuit a privilege during the lawsuit's duration. If the lawsuit results in a determination that the party was not entitled to that privilege, a court bond protects the opposing party from any loss resulting from the privilege. In some proceedings, the opposing party can file a "counter" bond to negate any effect of the privilege's having been extended to the first party.

Admiralty bond

A court bond produced for legal matters that relate to the sea or waterways.

Admiralty bonds apply in legal matters related to the sea and waterways. Cases that fall within admiralty and maritime jurisdictions are usually tried in United States federal courts. Federal laws require shipowners to post admiralty bonds. If the property of others (including cargo) is damaged, the bond guarantees that the principal will pay for damages and enable vessels and their cargoes to continue in their course of transit.

Fiduciary bonds are used for a variety of purposes. The word "fiduciary" refers to persons or legal entities, such as administrators, guardians, and trustees, whom a court appoints to manage, control, or dispose of property of others. Fiduciary bonds generally guarantee that persons entrusted with the care of property belonging to others will exercise their duties faithfully, account for all property received, and make good any deficiency for which a court may hold such fiduciaries liable.

Miscellaneous Surety Bonds

Many bonds have common characteristics that naturally place them in a classification, but some bonds have unique purposes that do not fall easily into any one classification. These bonds are called **miscellaneous surety bonds**. Governments require some miscellaneous bonds, such as the Airlines Reporting Corporation bonds, to protect the public. However, most miscellaneous bonds, such as the ocean transportation intermediary bond, arise from private relationships and support business transactions.

Miscellaneous surety bonds
A classification of bonds that do not clearly fall within the scope of the other commercial surety bond classifications.

COMMERCIAL SURETY BOND UNDERWRITING

An underwriter of a commercial surety bond must consider a wide range of factors to determine whether the bond will be profitable to the surety.

Successful underwriting requires an understanding of commercial surety bond characteristics and familiarity with surety bond forms and provisions. Some of those provisions, such as ones related to indemnity and collateral, are designed to protect the surety if the principal fails to live up to its obligations.

An underwriter must also have the expertise to evaluate a bond's obligations relating to issues such as when and under what conditions it can be canceled, term duration, liability of surety bond parties, and the potential for third-party lawsuits. Other underwriting considerations relate to the principal's ability to honor the surety based on issues including financial strength and insurance coverage.

Characteristics of Commercial Surety Bonds

Although commercial surety bonds address a wide range of situations, they all share certain characteristics that influence bond underwriting.

Three-Party Relationship

The three parties to a **surety bond** are the principal, the obligee, and the surety.

The **principal** s the person or organization that is primarily bound on a bond furnished by a surety. The principal has the duty to perform for the obligee's benefit.

The **obligee** is the party to whom a bond is given and who is protected against loss.

The **surety** is the party who answers to the obligee for the principal's debt, default, or miscarriage resulting from the principal's failure to perform as required by the underlying contract, permit, or law.

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.

Principal Becomes Liable to the Surety

If the principal fails to perform its obligation to the obligee, the surety must respond. The surety can fulfill the obligation or pay the loss up to the bond

Indemnify

To restore a party who has sustained a loss to the same financial position that party held before the loss occurred.

limit (the bond penalty). The principal must **indemnify** (reimburse) the surety for the amount the surety paid to fulfill the obligation.

Common law grants this right to sureties, and the indemnity agreement or the indemnity language in the application gives sureties further rights. Underwriters must consider the principal's ability to indemnify the surety for the amount of the loss and should also be aware of associated expenses in the event of a loss.

Surety Expects No Losses

The surety that issues a bond vouches for the principal's integrity, capability, trustworthiness, financial responsibility, or other desired qualities. A surety will not provide a bond unless the underwriter is convinced that the principal can perform the obligation that the bond guarantees.

By prequalifying the principal through careful underwriting and requiring collateral, when needed, the surety expects to sustain no losses. If a principal fails to satisfy an obligation and a loss occurs, the surety might be able reduce the loss amount by exercising its rights, which include the right to recover its loss payment from the principal or other indemnitors through salvage efforts.

Indeterminate Bond Term and Noncancelability

Commercial surety bonds usually terminate when the principal has fulfilled its obligations. A bond might guarantee an obligation that extends over several years, such as mine reclamation, so some surety bonds can be in force for an indeterminate period. Noncancelable bonds terminate only upon completion of the obligation. To evaluate bond risks properly, underwriters must consider the potential length of the obligations and the surety's ability to cancel the bond.

Influence of Laws

A statute is a written law. Surety bonds can be statutory (required by a written law) or nonstatutory (required, for example, by a contract):

Statutory bond

A bond that is imposed by statute.

- Municipal ordinances and federal or state laws or regulations mandate **statutory bond** obligations. The law specifies the conditions and provisions of a statutory bond and controls the obligations of the three bond parties, overriding any conflicting bond provisions. In some instances, the law even specifies the language of the bond.
- Written contracts (or work orders) between the principal and the obligee and the bond language define nonstatutory bond obligations.

Underwriters determine the extent of risk by carefully reading the laws that require the bonds and considering their effect on the bond obligations.