Overview of Suretyship

CHAPTER 1

Suretyship has a long history, as evidenced by references to it in the Bible and historical writings. Suretyship has played an important role in handling the losses that governments, businesses, and individuals face every day. This chapter provides a foundation for understanding suretyship and its role in finance and risk management. It describes the personnel involved in the suretyship process, the underwriting considerations that surround it, and the legal remedies available when a default occurs.

Suretyship has aspects in common with insurance and others in common with banking. This chapter compares and contrasts the risk management aspects of suretyship, insurance, and banking. Finally, it explains how sureties use reinsurance and cosureties to transfer and share excessive risk.

ROLE OF SURETYSHIP

To understand the role of suretyship in handling loss exposure, one must first understand what sureties are and how they transfer risk; why government entities require surety bonds and how such bonds often involve third-party beneficiaries; and how business and private entities use surety bonds.

Surety Bonds Defined

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.

Surety bonds are of two basic types: (1) contract surety and (2) commercial surety.

Contract surety bonds guarantee the performance of certain public and private construction contracts. In a typical contract bond situation, a project owner (obligee) wants to build a structure or to improve land. The project

Surety bond
A written contract in which one party guarantees another party's performance for a third party.

Principal
The party who bears primary responsibility on a surety bond and who has the duty to perform for the obligee's benefit.

Obligee
The party to whom a bond is given and who is protected against loss.

Surety
The party to a surety bond who answers to the obligee for the principal's failure to perform as required by the underlying contract, permit, or law.

Contract surety bonds
A classification of bonds that guarantee the performance on a construction contract.

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

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, including plumbers' license bonds, bonds for executors of wills, and financial guarantee bonds for the payment of workers compensation. Each type of bond demands a different underwriting approach.

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

Another branch of surety bonds, **fidelity bonds**, historically guaranteed employee honesty. Today, fidelity bonds have been replaced by employee theft (or employee dishonesty) insurance, which is usually included in a coverage form or policy that covers several crime perils in addition to employee theft or dishonesty. The name "fidelity" is still used to indicate issues of employee honesty.

Risk Transfer

Risk is the possibility of financial loss in an insurance context. Governments, businesses, and individuals transfer risks to prevent financial hardship resulting from events beyond their control. One risk-transfer mechanism that organizations and people use is the surety bond. The following are typical examples of losses against which governments, businesses, and individuals might protect themselves with surety bonds:

- A person in a position of trust steals or negligently invests the assets of a child's, incompetent person's, or deceased person's estate.
- A construction contractor fails to finish a project for one of the following reasons:
  a. The contractor wrongly uses contract proceeds or receipts from the bonded project for another project.
  b. The contractor has not adequately bid on the project and cannot complete it or pay obligations created in the performance of the project.
  c. The contractor has invested its company's surplus funds in nonliquid assets such as land, boats, or paintings.
  d. The contractor cannot pay unforeseen costs incurred in the project.
- A public official receives public funds and cannot account for them because of failure to protect them from theft.
- A business fails to pay fees, taxes, or penalties to a state or local government.
- The federal government loses revenue when importers or customs brokers fail to pay duties, fines, and penalties.

Bonds Required by Law

Surety bonds can be statutory or nonstatutory in form. The obligation of a statutory bond is prescribed by a municipal ordinance or a federal or state regulation or statute. Because the laws specify the conditions of a statutory bond, the obligations of all three parties are controlled not by the bond provisions but by the law involved. Federal, state, and local governments and courts have required crime insurance (fidelity bonds) and surety bonds through statutes (written laws), regulations, ordinances, and court rulings. For example, to protect public funds, legislatures have enacted laws that require the following:

1. 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. **Performance bonds** guarantee performance of the contract. **Payment bonds** guarantee payment of certain obligations incurred in the performance of the contract.
2. To qualify for office, public officials must post **public official bonds** to guarantee faithful performance of their duties.
3. *Fiduciaries* are people or legal entities that hold positions of trust, and courts appoint them to administer funds for others. They must post **fiduciary bonds** to guarantee faithful performance of their duties.
4. To qualify for licenses or permits, businesses and individuals must post **license and permit bonds** that guarantee their performance of obligations required by the licenses or permits.
5. State and local governments require bonding of their employees under blanket fidelity bonds.

Performance bonds
A classification of bonds that guarantee performance of the contract. The obligee will be indemnified for any loss resulting from the principal's failure to perform the work according to the contract, plans, and specifications at the agreed price within the time allowed.

Payment bonds
A classification of bonds that guarantee payment for labor and materials incurred in the performance of the contract.

Public official bonds
A classification of bonds that guarantee faithful performance of official duties.

Fiduciary bonds
A classification of bonds that guarantee the faithful performance of duties by persons appointed by a court to administer the property or interests of others.

License and permit bonds
A classification of bonds that guarantee the performance of obligations required by licenses or permits.

Third-Party Beneficiaries

Often, legally required bonds create third-party beneficiaries, which can be individuals or businesses. Third-party beneficiaries are the third parties who benefit from bonds. They are not principals, obligees, or sureties as previously described; they neither buy the bonds nor provide them—nevertheless, they benefit from them.

For example, federal and state governments require bonds for public building projects to guarantee that construction contractors pay third parties for labor and materials necessary for those projects. This labor and materials payment bond protects against the contractor's failure to pay subcontractors, laborers, and material suppliers whose services and supplies are essential for performance of the contract. The bond guarantees to the government ordering a building project that the contractor's obligations will be performed or, failing performance, that adequate compensation will be made. The subcontractors, laborers, and suppliers are third-party beneficiaries of the bond, and, as such, have the legal right to sue both the contractor and the surety for payment.