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Surety Bonds Timeline

(The following timeline information is not needed for the prelicensing Surety exam, but is supplied to you as personal miscellaneous information only.)

2,750 BC: Earliest known suretyship contract written on a Mesopotamian tablet. According to the contract, a farmer could not take care of his fields because he was drafted into the king's army, so another farmer offered to work the fields. The two agreed to split the profit evenly. A local merchant served as the world's first known surety by guaranteeing that the second farmer would keep his word.

1792-1750 BC: Suretyship first addressed in a written legal code—the Code of Hammurabi.

670 BC: Age of the oldest surviving written surety contract.

150 AD: Roman Empire developed first laws about surety.

1837: William L Haskins proposed the first surety company in America—the New York Guarantee Company. (Tasker, Murphy & Schwartzkopf)

1840: The first successful corporate surety, Guaranty Society of London, founded. (Tasker, Murphy & Schwartzkopf)

1853: New York enacted the first law allowing establishment of corporate surety firms.

1865: Fidelity Insurance Company became the first U.S. corporate surety company. (NYT)

1884: American Surety Company incorporated in New York and becomes the first U.S. company committed to surety underwriting.

1894: Congress passed the Heard Act, requiring surety bonds on all federally funded projects.

1898: U.S. Supreme Court heard American Surety Co. v. Pauly, its first surety case.

1908: Fourteen corporate sureties formed the Surety Association of America. (surety.org)

1917: The victorious defendants of the Venner v. New York Central Railroad Company et al. Supreme Court case collected a $50,000 surety bond in legal fees from the plaintiff. (NYT)

1930: First known surety bond against suicide written.

1931: Handbook of the Law of Suretyship and Guaranty written to clarify fulfillment of sureties.

1935: Miller Act passed requiring public work contracts exceeding $100,000 to obtain performance bonds. It also mandated payment protection for contracts exceeding $25,000.

1938: American Surety Company and New York Casualty Company develop a new "Discovery Bond," which protects businesses against old acts of employee dishonesty yet to be discovered. (NYT)

1942: National Association of Surety Bond Producers founded to represent the needs and interests of surety agents and brokers. http://www.nasbp.org

1971: Federal Trade Commission entered the insurance field for the first time by challenging the 1969 merger between the American General Insurance Company and Fidelity and Deposit Company of Baltimore. The merger had made American General the leading surety bond underwriter and the largest fidelity writer in the United States.

1991: Municipal Bond Investors Assurance Corporation began offering new surety bonds that covered deposits local governments put into banks. The First National Bank of Chicago was the first bank to use the bond. (NYT)

1993: Westpac Derivative Products, Ltd., became the first specialist in its market to use a surety bond. The bond was issued for $100 million and allowed the company to earn the highest triple-A ratings. (NYT)

2003: Surety insurance companies, including AIG and Travelers, pay an unheard-of $900 million settlement to Enron customers following the crash. (NYT)

Introduction to Suretyship

Suretyship is a term meaning one person or entity (the surety) guarantees another entity (the obligee) that the third entity (the principal) will or will not do something. In other words, contract surety bonds guarantee the performance or financial obligations of others.

Suretyship (bonds) is one of the oldest forms of financial service. In ancient times, a person might leave a family member as "surety" to another until an obligation or debt was discharged. Suretyship today is usually conducted by insurance companies and is evidenced by a written contract called a surety bond. Surety bonds are used to provide a wide range of guarantees. One type of surety bond may guarantee that a contractor will comply with all the obligations outlined in a construction contract and another may guarantee that an importer or exporter will pay duties as required by the United States statutes.

Most large property and casualty insurance companies have surety departments. In addition, there are some insurance companies for which surety bonds make up all or most of their business. In either case, for a company to write a surety bond in the United States, it must be licensed by the insurance department of one or more states in which the surety conducts business. ***A surety that wants to write bonds for federal government construction projects must have a certificate of authority issued by the U.S. Department of Treasury.***

A Surety Bond is a type of bond that guarantees that a principal will carry out the obligation for which the principal is bonded. A surety bond is most often issued to a contractor, a person seeking a license or permit, or a person involved in a court case. **If the principal fails to fulfill its obligation, the surety must fulfill the obligation or pay damages to the obligee**.

A Fidelity Bond is a type of bond that will reimburse an employer (the insured) for the **dishonest acts of employees**. Losses generally fall into one of the following categories of dishonest acts: Employee Dishonesty, Forgery, Burglary, Robbery, and Theft.

License required to sell bonds:

- ✓ *Property and Casualty Producers license* allows the licensee to sell bonds.
- ✓ ***Limited-Line License*** means the **producer** can sell ***only one type of product***. **Limited Line Surety License** allows the licensee to sell bonds.
- ✓ No pre-license education or continuing education is required, however, **an initial state Surety insurance exam is still required. A Surety License is a limited lines license.**

What is the Surety's Job? To protect public and private interests against financial loss resulting from a company or individual's bankruptcy or failure to perform a contracted service. **If the principal fails to fulfill its obligation, the surety must either fulfill the obligation to the obligee or pay damages to the obligee**.

- ***For example***: A contractor is awarded a building contract for a school. The principal (the contractor) will usually be required to provide a performance bond (or contract bond). The performance bond guarantees the obligee (the school) that the work will be completed in accordance with the contract. If the contractor (the principal) defaults, the surety will be responsible for completing the work or paying damages to the obligee (the school).

Period of Coverage**:** Surety bonds ordinarily do not terminate until the principal has fulfilled its obligation, which may take only a few days or as long as many years. Consequently, ***surety bonds are not issued as year-to-year contracts and they normally do not allow either the surety or the principal to cancel them.***

Fiduciary Bonds **(usually required by Court Order or by Statute)** guarantee that a fiduciary will faithfully perform duties and act in the best interests of the person being represented. ***A fiduciary is someone who has a legal right to handle the affairs of others. Fiduciary bonds are available for administrators and executors of estates.*** Fiduciary bonds are also issued to receivers in bankruptcy cases and to various trustees.

Fiduciary: a person or company holding assets in trust for a beneficiary. The fiduciary is charged with the responsibility of managing the money wisely for the beneficiary's benefit. *Some examples of fiduciaries are executors of wills and estates, receivers in bankruptcy, trustees, and those who administer the assets of underage or incompetent beneficiaries.*

General Contract Principles (2 items)

A. Essential elements of a contract:

Insurance policies are legal contracts and are enforceable by law. The ***Entire Contract Provision*** states the contract consists of the application, the policy, and any riders or endorsements. All statements on an application are deemed to be representations, not warranties.

A **contract** is defined as an agreement enforceable by law. It is entered into by two or more persons under which one agrees, for a consideration, to do or to refrain from doing an act in accordance with the wishes of the other party(s).

Insurance is a two-party contract between a company and an insured, where an insurer agrees, for some consideration, to provide benefits, reimbursement, or provide services for an insured. **Suretyship is a three-party contract that will be discussed**.

For the contract to be considered a legal and binding contract the following elements must be in place:

Consideration, Competent Parties, Offer, Acceptance, Legal Object (CCOAL)

1. **Offer…** The applicant makes the ***offer*** to the insurance company. The offer consists of both the signed, dated, completed application and premium. Remember, the legal contract is between two parties, the insurer and the insured. One must make the offer, and the other accepts it. Insurance, even though advertised by a company, must be initiated by the client.

2. **Acceptance…** The insurance company ***accepts*** the ***offer*** by issuing the policy. A ***counter-offer*** is made by the insurance company if it issues the policy other than how it was requested. The applicant ***accepts*** the ***counter-offer*** when the additional premium is paid, and the counter-sheet is signed by the owner/applicant (insured).

   Note: Offer and Acceptance together constitute an **agreement.** The agreement is meant to create a legal relationship.

3. **Consideration…** Means that something of value must be exchanged by all parties for the contract to be legal. <u>It is the signed and completed application</u>, <u>plus the premium from the insured</u>. If there is no application, the company does not know what policy you need. The insurance company issues a contract (policy) that represents a promise to pay.

4. **Legal Object…** For a contract to be legal, it must be for legal purposes only. This is why *insurance contracts do not cover intentional or criminal acts of the insured,* why there must be insurable interest, and why stolen property cannot be insured. A contract to commit a crime is not legal and cannot be upheld in a court of law.

5. **Competent Parties…** The insured must be of legal age, not be under the influence of intoxicants, and not be mentally handicapped. Any person 18 years of age or older will be considered of full legal age and may contract for or with respect to insurance. A person under 18 years old will be considered a minor.

   - Consent must be freely given in order to enter into the contract.
   - The meaning of the contract must be certain.
   - The contract must be possible. If the act is impossible or illegal, the contract is void.

B. Characteristics of an Insurance Contract:

1. **Contract of Adhesion** means that since ***the insurer prepares the provisions of the contract,*** and the policyholder simply **adheres** (or agrees) to them, a court will rule in favor of the **insured** if there is any ambiguity in the contract terms. The contract is issued as a take-it-or-leave-it proposition. The insured must accept it as-is.

2. **Unilateral Contract** means that one party is required to perform under the contract. The insurer cannot demand that the **insured** make the premium payments, but if the premiums are paid and a claim is made, the **insurer** is obligated to pay under the terms of the contract.

3. **Conditional Contract** refers to the fact that insurance contracts are conditional. That is, the insurance company is obligated to pay a claim based on the condition that premiums were paid and proof of loss was submitted to the insurance company.

4. **Aleatory Contracts** are agreements that have an *unequal exchange* of values. The insured will pay premiums, but may never file a claim due to a loss, in which case the consumer is paying more than the insurer. If there is a claim, the insurer pays out to cover the loss and will pay out more than the premium it has received from that claimant. An insurance contract is aleatory. The fact that a surety subrogates any money paid out negates the aleatory portion.

C. Parties to a contract:

The parties in a contract are the ones bound by the contract. An insurance policy usually has 2 parties, the insurer and the owner. In reality, the contract is still between the owner and the insurer. When we move into bonds, there are actually **3 parties** to the contract. The insurer or guarantor, the principal, and the obligee.

Special Note: Surety bonds are contracts and are subject to the statute of frauds and other common laws calling for certain types of agreements to be in writing. **Therefore, a surety bond is not enforceable unless it is in writing.**

1. **The principal (obligor)** — the party who has agreed to perform a contractual obligation.

2. **The surety** — the company providing the bond and agreeing to pay damages if the principal defaults. An individual could also act as a surety or indemnitor. If a bail bond has two or more indemnitors (guarantors), they would be listed as co-sureties or dual-sureties.

3. **The obligee (the one protected)** — is the recipient of the obligation. The party for whose benefit the bond is written, and to whom payment is made if the principal defaults.

Surety Contracts (15 items)

A. Definition of a Surety

A surety is a contract whereby one party (the Surety company or guarantor) promises another party (the obligee) that a third party (the obligor) will, or will not, do something.

There are 2 main types of bonds:

A surety bond promises something is sure to happen, *(e.g., the contractor will finish the roof)*. If the job is not complete, it is up to the surety to make sure it is done. The surety, then, is a "person" who accepts legal responsibility for another person's debt or behavior.

> "Person" as defined by law is an individual, company, insurer, association, organization, reciprocal exchange, partnership, business trust, or corporation.

A fidelity bond guarantees something will **not** happen; *e.g., no money will be missing…*

Surety guarantees activity, and fidelity deals with money.

B. Differences between Surety and Insurance:

1. How losses are paid

Differences between surety and insurance fields can be found regarding indemnification and subrogation rights. Principals must indemnify the surety company for any losses and the ***surety has subrogation rights*** against the principal who purchased the bond.

With insurance, the insurer agrees to indemnify the insured or another party on behalf of the insured and has ***no subrogation rights*** for paid losses against the insurer.

A surety bond is designed to protect the bonding company while an insurance policy is designed to protect the insured. ***Losses are NOT expected in the surety field,*** so ***premiums are not collected to pay losses but* are actually paid for service fees.**

Insurance companies are expected to have losses and charge premiums for paying those losses.

As an additional departure from Insurance contracts, Suretyship involves a continuous review process to determine that there is no negative change in the **3 C's** of a contractor and that the contractor's work program is progressing successfully.

2. Indemnity:

- The obligation resting on a person to make good a loss.
- The right which the person suffering the loss or damage is entitled to claim.
- Restoration to a victim of a loss by payment, repair, or replacement.

a) **Insurance** Claims are paid according to the terms of the policy. Premium continues to be paid. Regarding insurance, policies may be a valued policy or an indemnification contract. A valued policy is where the company pays the face value of the policy. Life insurance, scheduled items on a property policy like rings or artwork. Indemnification contracts are intended to make a person whole, back to the original position with no loss or gain. Most property & casualty and most disability contracts are indemnification contracts. An individual may have 3 life policies and upon death, each policy pays the face amount. If an individual were to purchase 3 auto policies and their car was stolen, each company would pay 1/3 of the loss.

***If I have collision coverage on my auto and there is a collision, the insurer will pay for the repairs and a rental vehicle while the car is being repaired. I am indemnified when the repair is completed and I have paid my deductible. If a $10,000 ring is lost and it is scheduled as a floater on my homeowners' policy, I will be paid $10,000. There will be no subrogation to me. — In other words, the insurer pays and continues to collect my premium, but that's it.*

b) **Surety** When there is a claim on a surety, the company investigates, and if there is a valid claim they refer it to the principal to take care of. If this doesn't work, the surety will do what is necessary according to the type of bond to fulfill the contract. They surety will then approach the principal for reimbursement for all sums of money spent, <u>including</u> claim defense costs (a.k.a. subrogation).

3. Two-party agreement

a) **Insurance:** An insurance contract is a legal contract between 2 parties, the owner and the insurance company. Insurance is defined by law as follows: "***Insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies."***

b) **Surety:** A bond is a 3-party contract. The 3 parties are the Obligee, the Principal or Obligor, and the Surety.

1) Insurance companies plan for insurance claims. They collect premiums from a large group of people in order to have money to pay claims. This utilizes the Law of Large Numbers, the larger the number of 'x', the more accurate the predictions.

2) Surety companies do not expect to pay claims. If and when they pay, they will go back to the responsible party to collect back what they paid out (subrogate).

4. Cancellation

a) **Insurance:** The owner of an insurance policy may cancel the contract at any time in writing to the insurer or by returning the policy. An insurance company may cancel for non-payment of premium always, but depending on the line of insurance must have a reason to cancel. Getting sick will not cancel a person's life or disability policy.

b) **Surety:** A bond could non-renew if it is not needed any longer. Some bonds are noncancelable, like a performance bond and other contract bonds. Part of the protection is the fact that they cannot be canceled. There are, as always exceptions to the rule such as before the work has started. The bond would not be needed and could be canceled but, to have premiums refunded, all copies of the original bonds must be returned to the surety.

Other types of bonds may be canceled with proper notice from the principal to the obligee (30-60 days). Unearned premiums will be refunded.

Canceling a bond may be done by the obligee in writing with a letter of release. A letter of release would be for probate bonds or other civil/judicial bonds and is contingent on the obligee verifying the principal has satisfied the obligation that required the bond.

Canceling may be done by the obligee by returning the bond in the event it was not used or the incorrect bond was purchased.

The bond may expire, *e.g., a guardian bond will expire when the minor reaches the age of majority.*

The principal may cancel the bond if they choose to. There is a 30-day cancellation provision. If the bond is required for a license, the license will be suspended until another bond has been purchased.

The surety may cancel as the underlying terms have been met, *e.g., in a bond to replace a roof, the work is done and the bond is no longer needed.*

Although full premium payment is due at inception, there may be a payment plan. If so and the premiums are late, there can be cancelation due to nonpayment.

Most bonds are continuous as long as premiums are paid. ***However, with Fidelity Bonds, coverage for an employee is canceled immediately upon discovery by the obligee of any dishonest act committed by that employee (the principal)***.

5. Binders

A binder is a temporary guarantee of coverage and is in effect until the policy issues. A binder may only be given by an agent as a representative of a company. Binders may be in writing or may be verbal. When a premium receipt is issued that also binds coverage a premium receipt must:

- Be given or mailed no later than the next working day.
- Clarify this is a binder, not the policy.
- Have the date, amount paid, full name of the carrier and the location of the home or principal office, name of the insured, effective date of coverage if not today's date, and the reason for coverage.

C. Obligation of the surety: A **Surety Bond** is a type of bond that guarantees that a principal will carry out the obligation for which the principal is bonded. A surety bond is most often issued to a contractor, a person seeking a license or permit, or a person involved in a court case. ***If the principal fails to fulfill its obligation, the surety must fulfill the obligation or pay damages to the obligee.*** The risk must be analyzed so the proper premiums are charged.

D. Parties to the Surety Bond — A surety bond is a contract between 3 individuals:

1. **The Obligee:** The protected party.

2. **The Principal:** The party who is to perform the contractual obligation for the obligee.

   The party who purchases the bond.

   The party who stands between the bonding company and the loss.

3. **The Surety:** The person who assumes the risk and guarantees the contract will be complete.

***E.g., The obligee is me, the person who needs a new roof. I hire a contractor, make sure they are licensed and bonded, and they start the job. If they stop with a portion unfinished and I cannot get in touch with them to finish the work, I contact the insurer. They, acting as the party who guarantees the work (the guarantor or surety), will refer back to the principal first, then find another company to complete the work according to the original specifications and pay them to complete it. The surety will then subrogate to the principal to be reimbursed any amount they paid out.*

E. Suretyship: Surety, whether **personal or corporate, is a guarantee that you will do something!**

a) Indemnification and General Indemnity Agreement

If the principal defaults, the surety pays the obligee. **The surety has the common law right to recover its losses from the principal under the rights of subrogation**. Under subrogation, only the bond penal amount (penalty amount) can be recovered by the surety and not any additional expenses or costs of the surety.

- **(General) Indemnity Agreement** — is a contract provision that allows the surety to go after the principal for the recovery of expenses, costs, and losses incurred by the surety over and above the bond amount. It, in effect, expands the subrogation rights.

The surety may not issue bonds unless it has received agreements from the principal and other indemnitors with sufficient assets to secure the surety from any claims that may be made against the bonds. This is done by an ***indemnity agreement to be signed by the principal and the individuals who will serve as indemnitors.***

The indemnity agreement sets forth and expands upon the separate common law obligations (subrogation rights) between the principal and the surety. A separate indemnity agreement may be issued for each bond or the parties enter into a **general indemnity agreement covering any bonds that the surety may issue to that contractor.**

b) *The* **indemnitors** ***(the contractor and individuals who have pledged their assets to support the bonds) agree that they will indemnify (completely reimburse) the surety for any liabilities, attorney's fees, expenses, or damages the surety may incur*** because of its issuance of a bond to the principal.

c) **Promise of Surety… If the principal fails to fulfill its obligation, the surety must either fulfill the obligation to the obligee or pay damages to the obligee. But then the surety has the right to recover its losses from the principal. This right of recovery is called subrogation and is part of common law.**

- In the event of a claim, the surety will investigate it. If it turns out to be a valid claim, the ***surety will pay it and then turn to the principal for reimbursement*** of the amount paid on the claim and any legal fees incurred. If the principal defaults and the surety turns out to be insolvent, the purpose of the bond is rendered void. Thus, the surety on a bond is usually an insurance company whose solvency is verified by private audit, governmental regulation, or both.
- ***A key term in nearly every surety bond is the penal sum***. This is a specified amount of money which is the maximum amount that the surety will be required to pay in the event of the principal's default. This allows the surety to assess the risk involved in giving the bond; the premium charged is determined accordingly.

d) **Promise of Insurance is to assume, for a specified time, the losses suffered by the insured**.

Insurance is a risk-sharing device that expects losses based on calculated probabilities. Though losses occur, bonds are structured and written with the expectation that few losses will occur and those that occur are recoverable. A bond closely resembles a **bank letter of credit**. The **surety** is lending its credit to a person or organization to back their service or performance of an obligation.

e) **Fidelity vs. Surety** — **Surety** is a person (or entity), who is legally responsible for the contracts, debt, delinquency, or liability of another. If there is more than one surety, it could be called ***Co-sureties or Dual-sureties***. **Two or more individuals may act to guarantee that the principal will return for court**.

Fidelity means faithfulness to obligations, duties, or observances. It means adherence to right, careful, and exact observance of duty, or discharge of obligations.

Fidelity Bonds are bonds that can protect business owners and employers from monetary or property loss at the hands of employees. Some businesses, including insurance companies, are required to utilize fidelity bonds. **Fidelity Bonds** are bonds issued to **protect an employer from financial or property losses due to the dishonesty of employees.**

Cancellation of a Bond: Most bonds are continuous as long as premiums are paid. *However, with Fidelity Bonds, coverage for an employee is canceled immediately upon discovery by the obligee of any dishonest act committed by that employee (the principal)*.

1. **Personal** In a personal suretyship, the individual assumes full responsibility for the principal debtor's obligations. It is someone the courts will accept as a guarantor (like a co-signer). An individual issues a bond and acts as a surety and provides the guarantees required. It can be more flexible than a corporate bond because you can set the terms of the agreement according to a person's needs. They may also be easier to obtain if a surety company turns the person down due to bad credit history. These types of bonds are generally used in probate situations.

2. **Corporate Suretyship** was first formed in the 1800s. Prior to that time, individual arrangements were risky and there were no guarantees that the assets of a backer would satisfy the obligation. Once organizations began to specialize in issuing surety bonds, formal contracts backed up by corporate assets became available to meet individual and business needs. Bonds are usually issued by insurance companies. A corporate surety is a company that charges for the guarantee.

   Corporate surety bonds are often available for a lower premium than a personal bond and since it is corporate, there are systems in place that can provide the bond quickly. Backed by a surety company the financial guarantee can be better.

   A corporate surety is a term to describe a bond issued by a company or corporation who is licensed under the laws of the state the bond is purchased in.

3. Role of U.S. Treasury

Most large property and casualty insurance companies have surety departments. In addition, there are some insurance companies for which surety bonds make up all or most of their business. In either case, in order for a company to write a surety bond in the United States, it must be licensed by the insurance department of one or more states in which the surety conducts business. ***A surety that wants to write bonds for federal government construction projects must have a certificate of authority issued by the U.S. Department of the Treasury.***

Treasury Department Circular No. 570 is published in the **Federal Register** yearly as of the first workday of July. As they occur, interim revisions of the circular are published in the Federal Register. **Surety companies issued a Certificate of Authority from the U.S. Treasury Department are published in the Federal Register.**

Financial Institutions (a.k.a. Banker's Bonds) have special exposures because they receive and distribute funds and handle transactions for clients. ***Various bonds are available to cover bankers, credit unions, finance companies, insurance companies, and savings and loan institutions***.

- Bonds for financial institutions provide broad coverage for multiple exposures and are similar to that provided by a commercial crime policy. ***One bond might be used to cover employee dishonesty, robbery, larceny, theft, or hold-up on or off the premises***.
  - For example: a **Banker's Blanket Bond** is a Fidelity bond that covers banks in the event of a loss due to the *dishonest act of one of its employees*. If a teller steals money from the bank they are employed by, the bank would be indemnified from the Banker's bond. Then the bonding company would go after the ex-employee for recovery of the money.
  - The Banker's bond would also protect a bank against losses from a variety of criminal acts: ***employee fraud, robbery, burglary, and forgery***.
  - **It does NOT cover errors made by employees, losses on inventory computation, or a profit-and-loss computation.**
- ***Fidelity coverage for an employee (the principal) is canceled immediately upon discovery by the obligee of any dishonest act committed by that employee.***

F. Underwriting considerations a.k.a. Pre-qualification function for credit…

Insurance underwriting is based on the fact that losses will occur, while surety is underwritten on the fact that losses will not occur. If they do, the surety is reimbursed.

The principal (or contractor in a contract bond) must qualify for a bond. **This process is very much like qualifying for a loan, line of credit or mortgage, or an insurance policy.** Underwriting is a risk selection process and requires information on an application regarding the principal. What is this for? Do you have any experience? What is your financial condition? Credit score?

Unlike with insurance, there is little expectation of loss with surety bonds. Because of that, the bond premium is typically meant to cover ***prequalification services***.

There are some bonds that do not require underwriting. These bonds have a pre-approved premium and are issued without a credit check or financial history review. They include notary publics, janitorial services, and insurance adjusters.

The primary service of the surety is prequalification. Therefore, the surety bond fee that a contractor pays (for example) is primarily for service and granting of surety credit. A surety offers financial backing for the contractor. It does not lend the contractor money, but rather commits its financial resources to back the commitment of the principal/contractor.

For example, with a Contract Bond, the surety company's process for prequalification analyzes the contractor's (principal's) entire business operation. The surety is backing the promise of that contractor to perform the contract. The company investigates and evaluates the contractor's capacity to perform a particular contract, determines their financial strength (capital), reviews their character, and may ask for personal or corporate indemnity.

- The surety bond producer (agent) assists the contractor with prequalification in the area referred to as ***the 3 C's of underwriting a surety bond:***

Capacity to perform;

Capital or financial strength; and

Character of the individual (personal information).

1. Capacity to Perform — typically includes analysis of:

- Resumes of the contractor and key personnel.
- Contractor's track record of successfully completed work.
- **Adequacy of the contractor's equipment and tools required to perform the contract.**
- Rationale for why the contractor is undertaking the project.
- Continuity plan that illustrates how the company will continue performing its obligations in the event of the demise or departure of key personnel.
- Contractor's future plans, goals, objectives, and growth strategies.

2. Capital (Financial Strength) — typically includes analysis of:

- Detailed financial statements for the past 3-5 years. Accounting methods should comply with Generally Accepted Accounting Principles (GAAP). Financial statements should include: Balance Sheet, Statement of Earnings, Statement of Changes in Owner's Equity, Statement of Cash Flow, and Contract Schedules.
- *The surety may ask for interim financial statements. Requirements for interim statements vary, but a six-month statement usually is the minimum.*
- Contract schedules that typically include a summary of completed contracts and contracts in progress. ***Sureties also will require a schedule of work in progress (usually quarterly).***
- Cost records that account for the financial status of the contractor's jobs.
- Credit reports demonstrating how the contractor handles payment of debts; and
- A bank line of credit showing unsecured credit that can be used as short-term working capital.

3. **Character** — Surety companies may review trade references from owners, architects, subcontractors, general contractors, material suppliers, etc., with whom the firm has worked to get a sense of the contractor's reputation for fair, businesslike dealings.

Indemnity Agreement — Surety companies may require the personal indemnity of the owners, their spouses, or major stockholder(s) of the construction firm to assure that they are going to put forth their best efforts to meet contract obligations. For a proper evaluation of what loss-paying power the personal indemnity provides, the surety may request the contractor to provide personal financial statements.

- The indemnity agreement sets forth and expands upon the separate common law obligations (subrogation rights) between the principal and the surety. A separate indemnity agreement may be issued for each bond or the parties enter into a **general indemnity agreement covering any bonds that the surety may issue to that contractor.**

- **As an additional departure from insurance contracts, Suretyship involves a continuous review process to determine that there is no negative change in the 3 C's of a contractor and that the contractor's work program is progressing successfully.**

G. Obligations under a surety bond

1. Contractual

Contract Bond… a guarantee of the performance of a contractor. In general, ***contract bonds are used to guarantee that the contractor will perform according to the specifications of the construction contract.*** If the contractor fails to perform according to the contract, the insurance company is responsible to the insured for payment, up to the limit of the bond, which is usually for an amount equal to the cost of the construction project. The insurance company then has recourse against the contractor for reimbursement.

Many performance bonds give the surety three choices:

1) Completing the contract or project itself through a completion contractor

2) Selecting a new contractor to contract directly with the owner

3) Allowing the owner to complete the work with the surety paying the costs

2. Statutory

Statutory Bonds are bonds required by law or statutes, usually with the intention of protecting the public. Some of the same bonds are required by statute and by the courts, such as Appeal Bonds.

Types of bonds that might be ***required by statute or law*** include:

- Federal Officials Bond… coverage for the federal government in the event of loss due to dishonest acts of federal government employees.

- Permit Bond… guarantees that a person licensed by a city or state agency will perform activities for which the bond was granted, according to the regulations governing the license.

- Securities Bond… protects the issuer of securities (stocks and bonds) against forgery of the securities.

- Appeal Bond… guarantees payment of the original judgment of a court. When a judgment is appealed, ***a bond is required by the court*** to guarantee that if the appeal is unsuccessful, funds will be available to pay the original judgment and the costs of the appeal. This serves to discourage an individual from appealing merely to stall for time or frivolous reasons.

- Bid Bond… bond required of a contractor submitting the lowest bid on a project. ***If the contractor then refuses to undertake the project, the bid bond assures that the developer will be paid the difference between the lowest bid and the next lowest bid.*** The bid bond encourages contractors to make serious bids and live up to their obligations.

- Notary Bond… Notaries are licensed through the states. A claim against the notary in his/her professional capacity is filed ***against the state*****.** **The surety company collects a fee to write the notary bond. If a claim is made, the surety pays out to the state, the obligee.**

3. Court order

Certain bonds are required by the courts. For example:

A ***court bond*** is a dollar amount set by a judge, which must be paid by the defendant charged with a crime, to ensure that the defendant returns for trial. A court bond can also be non-monetary — or "on your own recognizance" — meaning the judge believes the defendant will return to court on his/her own, without any disincentive from the courts. The bond can also be denied, and in the case of a homicide, usually is.

- The purpose of a court bond is to ensure a defendant returns to court. If the bond amount is paid, the accused may go home until the court date. If it is not paid, the defendant will be held at the local jail until the court case comes up.

- Bond, in many cases, ***is a set amount determined by the criminal statute*** that the defendant is accused of violating. Different classes of felonies and misdemeanors have different bond amounts. Sometimes, it is up to the judge's discretion; in others, it is not.

- Defendants usually don't need to pay the full amount of the bond. Most states have the ***10 percent rule, stating*** the defendant only has to pay 10 percent of the total bond set. That is the bail amount.

- There are typically four different types of court bonds that can be issued after a person is arrested. There is the *signature bond*; the *cash bond*, in which the arrestee must pay the bail amount upfront before he is released; *the 10 percent bond*, in which the arrestee must pay 10 percent of the bail amount upfront before he is released; and a ***surety bond***, in which a bail bondsman, who is approved by the court, promises the court that the arrestee will appear on his court date, and that if he does not, the bail bondsmen will pay the bail amount in full.

H. Power of attorney

— A legal instrument (contract) in writing by which one person *(e.g., a surety company)* appoints another *(e.g., bondsman or surety agent)* as their agent and confers upon them the authority to perform certain **specific acts** *(e.g., writing bonds for a surety company)* **on behalf of that person**. The purpose of a power of attorney is to evidence the authority of the agent to third parties with whom the agent deals.

- ***Because the bond agent has the "power of attorney" from a surety company, the bonding agent can write bonds and sign on the surety's behalf.***
- ***Bond principals give their power of attorney to the bonding agent to act on the principal's behalf.***
- **Authority Agreement is an agreement (or contract) between the agent and the surety governing the use of the Power of Attorney.**