

## Overview of Surety Bonds

### Principles of Surety Bonding

Paradoxically, surety bonding finds itself as an integral part of multiple line insurance business instead of commercial lending. Bonding has much more in common with the latter, considering the type of risk assumed and the means of transacting business. The financial obligation involved in surety bonding is underwritten in an entirely different manner than insurance.

Unlike insurance coverage and fidelity “bonding” surety bonding is essentially a three-party or tripartite obligation. It consists of:

- ✿ The Oblige, or the first party, to whom the indemnity is provided
- ✿ The Principal or Obligor, as the second party who performs or complies with contractual or statutory obligations for the Obligee (referred to as Owner on contract bonds)
- ✿ The Surety, as a third party, who guarantees that the principal will perform or comply with the contractual or statutory obligation.

The surety bond is a joint and several financial undertaking of the principal and surety. The former bears the full responsibility for performance of the obligation.

Unlike the typical, multi-page insurance policy, the surety bond rarely exceeds one page. The format of all bonds- as well as their eighteenth century language- is nearly identical. There are usually only three clauses that embody the entire obligation, as illustrated below in abbreviated form:

1. The recital, or “KNOW ALL MEN BY THESE PRESENTS” clause always cites the names of the parties to the bond, in which the Principal and Surety are joined and severally “held and firmly bound unto” the Obligee in the “full and just sum of” the amount, the penalty or penal sum of the bond.
2. The “WHEREAS” clause describes the nature of the obligation, such as:  
Whereas, John Doe has been elected to the office of Sheriff \_\_\_\_\_  
Whereas, the Principal has entered into a contract for (describes the Project) this \_\_\_days of \_\_\_
3. The “NOW THEREFORE” clause states that if the Principal shall well and truly perform the contract (Contract Performance bond), or serve faithfully in his or her office as an elected official (Public Official bond), or administer the estate of Mary Smith, deceased (Fiduciary bond) and so on ----“then this obligation shall be void; otherwise to remain in full force and effect”

The risk to the surety is underwritten on the basis of the three Cs: Capital, Character and Capacity. These credit evaluation standards are used by most grantors of surety credit, commercial bank loan providers and many other firms that extend credit as a normal business risk.

There is also a fourth C, or Collateral, which is used by many credit grantors to support abnormally hazardous surety obligations. It is also routinely used with the extension of

many commercial bank loans. Such additional support (collateral) for a credit risk does not necessarily impugn the credit worthiness of the bond principal or the party seeking a loan. With contract suretyship, the requirement for collateral by the “Standard” surety markets is highly unusual, except where a contractor has defaulted in the performance of bonded work.

Surety obligations (contract bonds in particular) are often dependent upon the officers and directors of a corporation personally indemnifying the surety against any loss they may sustain by reason of executing the bonds on behalf of corporate principal.

The Surety’s and lenders respective recourse against default follow similar avenues. An unsecured lender has nearly the same legal remedies against its defaulting borrower in civil proceedings as the surety does against its defaulting principal. In the surety field this is referred to as the right of equitable subrogation. If the lender has a guarantor or co-maker supporting the borrower on its security instrument, these third parties would be tantamount to the surety’s part as the guarantor to the obligee on a bond.

This book will provide the reader with an overview of the broad fields of the ancient art of suretyship, beginning with a caveat from wise King Solomon: “He that becomes surety for another shall smart for it.”

### Summary of Surety Principles

These threads are common to all surety undertakings.

1. All surety bonds are three-party (tripartite) commitments. In each agreement, the principal/obligator (the performer) and the surety (the guarantor) assure the obligee, or owner in contract surety, that the obligation undertaken by the principal will be successfully performed. After completion, the principal and surety are discharged from further liability. Failure to perform (default) often invokes demand for payment of some part, if not all, of the bond amount (penalty or penal sum)
2. Principles and surety are jointly and severally liable to the obligee. If the principal can’t perform, the surety must.
3. Except for most License and Permit bonds, the surety has no option to cancel its obligation before the performance by a principal has been completed.
4. A surety can mitigate its exposure through requiring support of personal, partnership or corporate indemnity on behalf of the principal. Therefore, if the principal defaults, the surety can look to the indemnitors. A word of caution: It has often been said that indemnity is a good crutch to lean upon, but not too heavily. A surety indemnitor, like a bank guarantor is not jointly and severally liable with the principal/borrower. Any recovery should include application of credits, salvage in surety cases, unearned interest on bank loans and collateral, if any, before demand can be made upon the indemnitor/guarantor to recover any remaining loss.
5. Once the surety sustains a loss on behalf of a defaulting principal, the rights of recovery enjoyed by the obligee against the principal and surety are subrogated

(substituted) to the surety. The same rights would pass to loan guarantors against the makers (borrowers) once they had to make good on a loan default.

### **Surety Premium v. Insurance Premiums**

In insurance, Fire, Automobile, Liability, Inland or Ocean marine, Accident, Health and Life, the law of large numbers rules. It is expected that sufficient premium will be collected from the policyholders to cover possible losses. Pooling financial resources (premiums) to respond to injury or damage suffered by certain members of that pool is still valid as a workable insurance philosophy.

That philosophy does not necessarily apply to corporate suretyship. The premium of a Surety bond, whether Contract, Fiduciary, Licence, Permit etc., is not an amount that can act as an outgoing payment reservoir. The premium is rather a fee for the bond. When losses occur, they are paid out of the surety's assets and surplus investment income and its contingency reserve. After the surety fulfills its obligation, it assumes rights of the principal since they are also taking on the responsibilities of the principal. A delivered Surety bond is valid even when a premium has yet to be paid. The bond is binding upon the surety regardless of whether the principal, the purchaser of the bond, pays for it. The surety bond contains no provision for cancellation through non-payment or premium, and the rights of the obligee may not be invalidated unless there is an express provision in the bond to that effect.

Surety bonds and insurance policies share many similarities, but some very distinct differences also exist. Besides containing different contract language, the forms vary in the coverage they provide. The following may help identify the most important differences. See Addendum #1 for a chart illustrating some of the key distinctions.

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