Chapter 1

What Is Surety?

In This Chapter
- Understanding the difference between insurance and surety
- Working to help the project stay on track
- Understanding why the government likes surety bonds

Think of surety like a money-back guarantee. If you’re a developer planning a major construction project, surety is the guarantee that the construction firm will build your building as specified in your contract. If your company is entering into an obligation with a governmental agency or bureau, a private entity, or a federal, state, or local court, surety gives that entity some peace of mind that you’ll fulfill the obligation as promised. Surety can help guarantee just about any obligation that your company can find itself entering into.

Surety writing has created a big business — roughly a five billion dollar industry in the U.S. alone. And the U.S. makes up more than half of the world’s surety business. Even so, the business as a whole is still much smaller than many of its customers — if it were just one company, it would barely make it into the Fortune 500.

A lot of people think of surety as something that is for construction companies and building projects. It is, of course, and that’s often known as contract surety, which provides performance bonds guaranteeing that the contractor will perform the work, and labor and material bonds which ensure that the contractor will pay all vendors and subcontractors (there are even bid bonds ensuring that a contractor will, if awarded a contract, enter into that contract and obtain the other surety bonds that it requires). What many people don’t realize is that commercial surety, covering all sorts of business and legal dealings away
from the construction site, makes up some 40 percent of the surety industry. For a visual, see Figure 1-1.

![Pie chart showing 60% contract and 40% commercial surety](image)

**Figure 1-1:** Percentage breakdown of different types of surety.

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**It Sounds Like Insurance, but It’s Not**

You can be forgiven for thinking of commercial surety as a form of insurance. After all, “surety” and “insurance” have a root word in common, and in the U.S., insurance companies tend to be key players in the surety business. But surety and insurance are *not* the same thing.

Think of it this way — no matter what, we’re all going to die someday. You know it, and so does the insurance company that sold you a life insurance policy. And your health insurance company is pretty darned sure that you’re going to get sick and go to the doctor someday. Your car insurance carrier knows that every day a bunch of people are going to drive their cars into a tree or a deer or another vehicle. The whole business of insurance revolves around the assumption that at some point, customers *will* be using their insurance.

What insurance does is bring together a group of customers who essentially toss some money into a hat, with the knowledge that if and when they have a need or a loss, they’ll get back some of that money. The group is sharing the risk. With insurance, there will be losses, no doubt about it, and it’s the job of actuaries to anticipate what those losses are likely to be and make sure there’s always enough money in the hat.

With surety, on the other hand, losses aren’t a certainty, and in fact everyone is trying hard to avoid them. Rather than insurance, the concept of surety is really more like credit.
A surety bond provides significant protection. In the case of a supply bond, it protects the obligee should the principal fail to supply its products or services, or in case the principal goes out of business. In the case of a customs bond, it guarantees that tariffs and duties will be paid and that the principal will abide by customs laws and regulations. In the case of a construction project, it protects project financing should a contractor fail to perform or simply fail to stay in business, and helps to ensure that the project will be completed. It also helps to make sure that subcontractors, suppliers, and unions get paid as they’re supposed to.

A surety bond is a guarantee that a company or individual will live up to a specific obligation. That individual or company is the principal, and if the principal meets that obligation, the customer is happy. If the principal doesn’t deliver as expected, then the beneficiary, also known as the obligee, may make a claim. The third party in this deal is known as the surety or guarantor. This is the company that will be paying up on that guarantee if the principal doesn’t follow through as expected.

This arrangement points to one difference between insurance and surety. Insurance is essentially a two-party agreement involving you and the insurance company. But a surety bond involves three parties (see Figure 1-2):

- **The principal**: The entity that’s supposed to be performing the work or fulfilling the obligation.
- **The obligee**: The beneficiary for whom the work is being done or the party to whom the principal is promising that it will live up to its obligation.
- **The surety**: The company that is making the guarantee on behalf of the principal to the obligee.

So how is the concept of surety like credit? The company guaranteeing the surety bond has absolutely no desire to have to pay, just like a banker making a loan will do its best to avoid losing its money permanently. So, like the banker, the surety underwriter is going to do some investigation of the principal in order to feel comfortable making a guarantee on that principal’s behalf. The surety, quite simply, doesn’t expect to suffer losses.
Figure 1-2: The three parties involved in a surety bond.

The due diligence, also called **underwriting**, performed by the surety before issuing a guarantee is clearly good protection for the surety, but it’s also a confidence-builder for the obligee who is issued the surety bond. Requesting a surety bond is a great way to prequalify potential manufacturers, suppliers, or contractors. The obligee knows that the surety has investigated the principal to be sure that the company is reputable, well-heeled, and well-qualified to do the work. Knowing that the surety has done its homework can reduce worries and administrative burdens and costs for the owner, and even serves to stimulate competition among principals.

Another difference between surety and insurance is that each time a company purchases an insurance policy, it is protecting its assets, whereas each time a company purchases a surety bond, it exposes its assets due to the indemnity agreement that it has provided. Again, this is why surety is more of a client relationship.

Rate and indemnity are other reasons why surety isn’t insurance. Please take a look at Chapter 3 for more on these topics.

**Going to the Surety Market**

A simple understanding of surety is that it’s a promise to pay up if the principal messes up, but the more complicated truth is that it’s in the best interest of the surety or guarantor to keep things from getting messed up in the first place.
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A brief history of surety

Companies have been issuing surety guarantees in this country for about a century, but the concept is much older. In fact, surety is mentioned in the Bible in the book of Proverbs, and shows up in ancient Roman ordinances. Archeologists in the Mesopotamian region uncovered a clay tablet on which a surety contract was apparently etched around 2750 B.C.

In this country, surety was used informally for generations. In 1894, Congress passed a law called the Heard Act requiring a combined performance and payment bond covering all federally funded projects. Lawmakers followed up in 1935 with the Miller Act, the most recent update regarding public sector surety, which requires separate payment and performance bonds on all federal contracts over a certain financial threshold. Nearly all of the states and many municipalities have passed similar measures, often referred to as “Little Miller Acts.”

Thus, the surety is working with the principal to try to avoid default. Sometimes the obligee isn’t even aware of the efforts that the surety has undertaken to keep the project on track. For example, a cash-flow problem on the part of a principal may mean that subcontractors or vendors can’t be paid. That, in turn, would threaten to torpedo the whole project and send the principal into a tailspin. In a case like that, the surety might choose to help make those payments temporarily in order to keep the principal and project afloat, and thus avoid having to pay a claim on the surety bond.

A surety looks at many factors when underwriting an account. It examines the principal’s credit rating, to see whether the principal is investment grade. Companies that aren’t investment grade can still obtain bonds, but perhaps at a higher rate, or the company may need to post collateral. The surety looks at the financial strength of the company, as well as cash flow and the quality of its financial presentation. The types of bonds needed and the duration of those bonds are also a factor for a surety in determining whether it can provide bonding for a company. Finally, the geographical needs of the principal also come into play.
Of course, your broker is your main point of contact in working with a surety. Your broker starts the dialogue with the surety company. Then, the broker will negotiate the rate and indemnity agreement with the surety, along with any collateral requirements. Working with the surety, your broker will set a single and aggregate limit for your account.

**Governments and Surety**

Why are governments so interested in surety bonds? Because they want to be comfortable with the money they’re spending on behalf of the public. They want to be sure that those companies with which they’re dealing are really going to deliver on their promises — whether they’re constructing buildings, performing road work, or providing services.

Government entities requiring surety bonds may be local, including a city, township, or county, maybe a water authority, or perhaps a local court. States are big users of sureties, including transportation and general services departments as well as state courts. And the federal government is into surety big-time — everything from the military, including the Department of Defense, to the Veterans Affairs, Customs, and General Services departments (and practically every other federal bureau or department). Federal courts require surety bonds, too.

Public entities clearly are among the biggest fans of surety bonds, thanks to the Miller Act and the state and local ordinances that some have referred to as “Little Miller Acts.” But surety bonds are also often required by private entities — including developers/owners of construction projects, general contractors, and banks.