# SURETY BONDS

## THEY'RE NOT JUST FOR CONSTRUCTION PROJECTS ANYMORE

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In today's increasingly competitive commercial environment, companies are required to manage a variety of competing and often substantial financial obligations. In many instances, companies are often required to post security for these financial commitments. Required security can take the form of a variety of security instruments, including cash escrows, letters of credit or surety bonds. Increasingly, surety bonds, which have been traditionally used in the construction industry, are proving to be a flexible and cost-effective alternative to cash escrows and letters of credit for companies that must post security for their financial obligations. Surety bonds in the form of a lease guarantee bond can be used to guarantee a variety of obligations where letters of credit or cash escrows are currently utilized. Surety bonds offer several advantages over letters of credit, including the following: (i) surety bonds afford potential cost savings; (ii) surety bonds are typically classified as off-balance sheet or contingent liabilities; and (iii) surety bonds offer better protection for the issuing company.

A surety bond is defined as an instrument under which one party guarantees to another that a third party will perform a contract or an underlying obligation. More specifically, a surety bonding arrangement involves a promise by which a surety, i.e., an insurance company, becomes accountable to another person, i.e., the obligee, for the debt, obligation or conduct of a third person, i.e., the principal. As a three-party agreement, the benefit of the bond inures to the obligee, but allows the principal to obtain work, or to satisfy statutory or legal requirements while also serving as a form of guarantee when required or needed.

Surety bonds can take two broad

forms: contract bonds and commercial surety bonds. Contract bonds involve the guarantee of performance of an underlying contract and payment to subcontractors, suppliers and laborers. For construction project owners, completion of the project within the budget is the primary goal. When it comes to limiting the financial exposure of contractor default, choosing the best form of risk management can make a big difference. Contract surety bonds are most often issued in the context of bid bonds, performance bonds and payment bonds. A performance bond protects the owner, i.e., the obligee, from the non-performance and financial exposures, including liens for non-payment should the contractor default. The labor and materials payment bond protects subcontractors, laborers, and material suppliers against non-payment of the contractor.

Commercial bonds guarantee performance of obligations that generally do not arise from contracts and include several distinct classes of bonds: contract bonds, court bonds (both judicial and fiduciary varieties), license and permit bonds, and federal and public official bonds. Beyond that, there are all kinds of miscellaneous bonds, including lease bonds. Lease bonds, although underwritten as a miscellaneous commercial surety bond, serve essentially as a financial guarantee required by landlords.

A common scenario occurs when a lessee consents to a very long-term commercial real estate lease agreement and the obligee i.e., the landlord, has concerns regarding the lessee's operational continuity and financial stability. Lease guarantee bonds are commonly used where the landlord is expending significant sums to make leasehold improvements in furtherance of a lease to incentivize a tenant to enter into a long-term lease arrangement. Lease guarantee bonds are generally drafted to reflect the specifics of the real estate deal and because there is a substantial component of financial guarantee risk involved, underwriting is critically important.

It is important to remember that surety bonds are not insurance but rather a third-party guarantee. One of the key ways surety bonds differ from insurance policies is that with insurance there is an assumption that losses will occur and the risk is spread among many individuals paying experience rated premiums. An insurer typically does not expect to recover losses resulting from many types of claims. On the other hand, sureties operate on the general principle that every bonded individual or business will perform as promised. There is no specific transfer of risk between the principal and the surety. Rather, the principal retains all responsibilities as it relates to the obligee. In addition, the premium charged for a surety bond is a fee for services, including investigating the applicant and handling the transaction. From an underwriting perspective, there is a fundamental assumption that there will be no loss. If the surety pays a loss on a bond, it will seek a remedy or recourse against the principal under its indemnity agreement and expect to be made whole again.

Another key element is that suretyship underwriting principals are more analogous to banking than insurance. A surety bond is underwritten by the surety company on the credit worthiness and the capacity of the principal to fulfill the underlying obligation. The surety company will also only entertain clients and principals who have the character and management integrity to fulfill the primary obligation. More specifically, in a typical surety underwriting scenario, the surety assesses the principal's financial capacity, capabilities and character to perform its obligation under the indemnity agreement. Depending on the type and term (length) of the bond, certain prerequisites may be more important than others. For example, due to the pure financial guarantee language of lease guarantee bonds, the principal's creditworthiness and financial strength is an absolute prerequisite for the surety underwriter to be comfortable that the principal is and will continue to be profitable for the number of years that the bond will be in effect. Typically, for most bonds, surety underwriters will need to look at the complete credit profile of the principal, including but not limited to: company organization chart, including breakdown of ownership; CPA-prepared fiscal year-end financial statements; copies of bank lines of credits; and possibly personal financial statements of the stockholders in order to assess the overall surety risk profile of the principal.

No underwriter ever intends that a surety bond run on forever. Whatever the principal's obligation is, it should be capable of eventual fulfillment in due course. Surety underwriters cannot be expected to guarantee any person's or firm's financial responsibility in perpetuity, unless there is full collateral. Therefore, whether or not a bond can be cancelled is an important underwriting factor to be considered. The right to cancel does not mean the surety can be excused from liability for acts of its principal that occurred while the bond was in effect. It does mean, however, by simply giving reasonable written notice to the obligee, a surety can be relieved from liability in the future. Such a clause is advantageous because circumstances change.

In order to determine whether a bond can be cancelled or the surety needs to withdraw, the bond form must be reviewed closely. It usually indicates how the surety can terminate its liability. For example, some bonds are cancelled by the surety, giving the obligee a 30-, 60- or 90- day written notice via certified mail. If the bond does not include a procedure, it will reference laws or statutes that contain the cancellation requirements. Some bonds are simply non-cancelable and the exposure remains with the surety until the obligation has been met or the surety has remedied a default. The obligation of a bond requires the partners to possess a knowledge of the law governing the bond, the bond form, and any regulation or statute(s) promulgated by the enforcing authority. If a bond is required by statute or ordinance, it is generally impossible to understand the surety's obligation without studying the underlying law.

Surety bonds in a commercial context are increasingly a viable alternative especially for businesses that maintain large cash deposits and where the firms are required to post security for financial obligations such as lease obligations, utility deposits and/or environmental financial assurances. Similarly, a surety bond can be used by any business or company that needs to post counter-party security for financial obligations tied to insurance programs. Treasurers, CFOs, risk managers and corporate counsel should be mindful of the flexibility and increasing use of surety bonds in the commercial arena. While there is an increase in the issuance of surety bonds in both construction and commerce, commercial surety in particular has expanded significantly. Indeed, it is fair to say that surety is not just for "construction" anymore.

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