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41 USC 431a Must Be Amended to Exempt the Miller Act

41USC§ 431a provides for automatic periodic inflation adjustments to procurement thresholds. Certain thresholds, however, specifically are excluded from this provision. **The threshold for construction contracts that must be bonded under the Miller Act should be added as an exclusion**, since increasing this threshold will expose more small construction businesses to loss of payment protection on federal construction projects. The Miller Act is a statute that was put in place for protection: protection for subcontractors and protection for US taxpayers.

Many subcontractors and suppliers on federal projects are small businesses. These small businesses often find that their only avenue into the federal procurement arena is as subcontractors and suppliers. Surety bonds, in the form of payment bonds, ensure that they get paid, whether the general contractor on the project pays them or not. Such protections cannot be allowed to be compromised as a result of automatic adjustments for inflation. Each automatic adjustment, which may occur every five years, in turn may mean an increase in the threshold so that many more federal subcontractors and suppliers perform work on federal projects without the protection of payment bonds. In the same vein, automatic adjustments to address inflation should not be the reason to decrease the protection provided by performance bonds to the US taxpayers. These bonds protect the taxpayer from loss if the contractor on a federal project defaults.

Congress recognized that certain protections should not be subject to this automatic adjustment. Specifically, Davis Bacon is excluded from the application of this automatic increase to protect the payment of wages to laborers on federal projects. The same basis applies to excluding the application to surety bonds to protect payments to subcontractors and suppliers performing work on federal construction projects.

The Federal Acquisition Regulatory Council already has relied on 41 U.S.C. § 431a to increase the threshold for payment security under the Miller Act. In 2006, the contract size threshold for payment security on federal construction projects was increased from \$25,000 to \$30,000. Now the Council proposes an increase to the threshold for performance and payment bonds from \$100,000 to \$150,000. Dramatically increasing the number of contracts where protection to small businesses and taxpayers is not provided. Clearly this dramatic increase is a bad idea, but one mandated by the current statute.

Please amend 41 USC 431a(d)(1) by inserting “3131 through 3134,” after “sections”. The payment protections afforded small businesses performing work on federal construction projects cannot be comprised by automatic adjustments for inflation!



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Revitalizing the SBA Bond Guarantee Program

The SBA Bond Guarantee Program (Program) was created to ensure that small and emerging contractors have the opportunity to bid on public construction work, grow their businesses and remain a viable part of the US economy. Surety bonds are a vital mechanism to protect taxpayers and workers on public construction projects from the danger of contractor default. Small businesses must have access to these bonds to obtain federal construction contracts, and the SBA program assists them in obtaining these bonds. However, over the years, the Program has become increasingly less effective. Significant reform is necessary to enhance the opportunities for small businesses.

Critical changes must be made to maximize use of the Program.

Streamline the SBA Bond Program into a Unified Government Program With Enhanced Characteristics

As the SBA Bond Guarantee Program has evolved, there are two plans under which sureties can participate in the Program. The Prior Approval Program ("Plan A") was the original SBA bond guaranty program. In this program, the surety must obtain SBA approval for each bond prior to writing the SBA guaranteed bond. The SBA indemnification of the surety's loss as a result of a bond claim in Plan A is 80%, and 90% for bonds written for socially and economically disadvantaged contractors and bonds written for contracts under \$100,000. The second program is the Preferred Surety Bond Program ("Plan B"). Under this plan, sureties apply to participate, submitting information up front on their underwriting practices and financial strength. Once a surety becomes a participant in Plan B, it is given an aggregate limit of bonds that it can write within the Program. As long as the surety complies with all of the requirements of Plan B, all bonds written within the program qualify for reimbursement of losses. The SBA does not review or approve each individual bond before it is written and the guarantee attaches and in Plan B, the surety receives a 70% indemnification.

In order to guarantee more bonds and to provide better assistance to small and emerging contractors, the structure of the SBA Surety Bond Guarantee Program must be changed. There are several reforms necessary to achieve this:

- Combine the SBA Prior Approval Program and the Preferred Program into one bond guarantee program, creating a unified model consistent with the Preferred Program. The SBA has done its own study of the structure and administration of its Bond Guarantee Program. The results of this study have yet to be released to public. It is our understanding that the recommendation to streamline the program will be supported by the SBA study and that the study could include vital information on how best to implement such a program.
- Require the SBA to track the contractors that participate in the program. The surety industry believes that the SBA Reauthorization Act should revitalize the SBA program so that it is attractive to sureties and agents and assists small and emerging contractors in obtaining their first bonds and graduating from the program into the traditional surety market. Although these contractors may continue to obtain some bonds through the program, there should be a common understanding between the surety industry, the SBA and Congress about what constitutes success for the program.
- Ensure that the SBA Bond Guarantee Program regulations keep pace with changes in law and practice in the construction and surety industries. Current SBA regulations, for example, require notice to the SBA of change orders exceeding a certain amount, but most construction contracts and bonds now require the surety to waive notice of such changes. Construction projects are delivered by new methods, such as design build. As another example, the SBA Bond Guarantee Program currently does not provide guarantees for design-build contracts, even where the design liability is carved out from the coverage of the bond.
- Create a system of due process in connection with the SBA Bond Guarantee Program so that sureties receive notice, a hearing and right to appeal if: 1) the SBA denies a surety's request to participate in the Program or eliminates a surety from the Program, or 2) denies a claim under a bond that the SBA has guaranteed. Such a process currently exists for the SBA loan programs but is absent for the SBA Bond Guarantee Program.
- Review the current fee structure of the Bond Program and establish reporting mechanisms concerning why fees continue to increase. The focus of the Bond Guarantee Program should be to provide increased contracting opportunities for emerging contractors and not to recoup administrative costs to fund the Program. Not ARRA
- Recognize that the SBA Bond Guarantee Program serves a useful public policy function and that it may not be self-sufficient each year. There always are competing interests in any federal budget. Congress, however, has never required the SBA Bond Guarantee Program to be self-sufficient. The Congressional declaration of policy for all the SBA programs in the Small Business Investment Act of 1958 was to stimulate and improve the economy by establishing assistance programs for small businesses, which are to be

“carried out in such a manner as to insure maximum participation of private financing sources.” (15 USC Section 661). If the purpose of the program is to help small and emerging contractors that may not otherwise qualify for bonds in the marketplace, it stands to reason that there will be losses. The most recent direction from the Office of Management and Budget (OMB) was two years ago when the OMB directed the SBA to increase its fees to cover SBA losses represent a major shift in philosophy and direction for the SBA program and are in conflict with the spirit of the law. The public policy of helping small and emerging contractors is a sound one, and it needs to be supported in the funding structure and reauthorization of the SBA. Not ARRA

Apply the Enhancements for Loan Guarantees under ARRA to SBA Bond Guarantees and Continue other ARRA Reforms

President Obama recently signed the SBA’s appropriations bill, which included \$125 million to continue the enhancements of increased guarantees and reduced fees for the SBA’s two largest loan programs through February 28. The enhancements were enacted in the American Recovery and Reinvestment Act (ARRA). The SBA estimates that the additional funding will support \$4.5 billion in small business lending and ensure that small business owners have the tools that they need to drive economic growth and create local jobs. Prior to the passage of ARRA, banks were reluctant to provide loans to small businesses that needed access to capital for business continuation and growth. According to an article that appeared in the *Washington Business Journal*, bankers cited reforms adopted in ARRA, such as the SBA eliminating fees on 7(a) and 504 loans and increasing the maximum government guarantee that banks loan to small business from 85% to 90%, led to an immediate nationwide increase in lending. Such reforms were not included in ARRA for the SBA Surety Bond Guarantee Program, despite the surety industry’s requests to do so. These reforms should now be implemented in a similar manner in the SBA Bond Guarantee Program to provide a similar boost to the bonding program.

In order to increase access to bond guarantees by small and emerging contractors, the following changes should be considered:

- Increase the SBA guarantees to sureties so that they are up to 95% of the bond amount for a period of 18 months and 90% thereafter. This should help increase greater surety company participation, similar to the response experienced in the SBA Loan Program.
- Require the Administrator to reduce or waive fees paid by contractors and sureties in the Bond Guarantee Program for 18 months, with authority to extend the time period for such actions. The construction industry currently has a higher percentage of unemployment than the country as a whole. While there may be indicators of economic improvement, there is an 18 month lag before any changes in the economy will be felt in the construction industry. The current fees to contractors may put them at a competitive disadvantage in the bidding process, which hurts them rather than helps them obtain public projects. The existing fee structure makes the program economically unattractive for many sureties and could affect the continued viability of the program.

- Make permanent the temporary changes enacted in ARRA in regard to higher contract amounts for bond guarantees.
- Make permanent the discretion given to the Administrator under ARRA to determine the Program's liabilities. A deterrent to participation in the SBA Program has been the denial of reimbursement to the surety after a claim has been made on the bond issued and guaranteed through the Program.

A Coordinated Approach and Vision is Needed to Put all Available Federal Resources to Work for the Benefit of Small and Emerging Contractors

“Small businesses are the backbone of the American economy,” Administrator Mills and Treasury Secretary Timothy F. Geithner wrote in their Small Business Financing Forum Report to the President. The construction industry serves as the catalyst for the emergence of many new such small businesses. Construction is a challenging and competitive business environment that demands specialized knowledge and skill sets of business owners, especially small and emerging businesses. Subsequently, it is essential that the SBA provides the necessary skills needed for these small and emerging businesses to compete and survive in the marketplace. Moreover, it is important that these businesses receive the necessary educational training on business and risk management topics so they graduate out of the SBA Bond Guarantee Program with the goal of qualifying for standard surety credit.

In order to establish a holistic business approach model, the SBA Bond Guarantee Program should consider the following reforms:

- Establish better internal coordination and communications between the SBA Bond Guarantee Program and other SBA small business programs, such as those relating to loan guarantees and business assistance. When a small business applies to any of the SBA programs in any of the SBA offices, a case file should be opened and communications should be opened between all SBA programs that can provide assistance to the contractor. The needs of small business should be reviewed so that it can be connected to the proper SBA program, i.e. loan, bond or other programs administered by the SBA. This should not delay any SBA program from providing the small business the specific assistance sought. If the business is a small and emerging contractor, for example, the SBA Bond Guarantee Program should proceed to provide a bond guarantee while other SBA programs review the contractor for collateral or other assistance.
- Implement the required interagency coordination. With loan and bonding programs in the SBA and DOT, and similar programs in the Department of Veterans Affairs proposed in this bill, coordination is needed among the various federal programs. H.R. 4253, enacted on February 14, 2008, provides a model for coordination. The Military Reservist and Veteran Small Business Reauthorization and Opportunity Act of 2007 requires the President to establish an interagency task force to coordinate the efforts of all federal agencies that are involved in increasing capital and business development opportunities for small business owners and service disabled veterans. The law directs the interagency

Education and Access to Needed Professional Services are Essential

Congress should consider funding grants and establishing free standing educational programs to assist veteran, minority- and women-owned small businesses to improve their ability to compete in the construction industry.

Legislation (H.R. 3771) has been introduced that amends the SBA Act to create grant and mentorship programs, which should be considered as part of the SBA Reauthorization Act. Specifically, H.R. 3771 would:

- Provide grants up to \$15,000 to women-, minority- and veteran-owned construction firms in order to obtain funds to hire professional services such as legal, accounting and other advisers.
- Create a second grant component, which establishes a free standing educational program to provide grant funds to colleges, universities, vocational/technical schools, community colleges and business leagues or not-for-profit entities to develop and administer a small business construction executive business and risk management curriculum in conjunction with local professionals, such as accountants, attorneys, risk management experts, financial experts/bankers, surety bond producers and local professional and trade associations.



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Creating and Enforcing Reasonable Small Business Participation Rules

Small Contractors vs. Contract Bundling

The Small Business Reauthorization Act of 1997 defines contract bundling as “consolidating two or more procurement requirements for goods or services previously provided or performed under separate, smaller contracts into a solicitation of offers for a single contract that is unlikely to be suitable for award to a small business concerns.” In essence, because these large contracts run longer and encompass a greater scope, they reduce the number and frequency of opportunities for small businesses to bid and be awarded federal work.

Changes were made in the federal procurement process in the 1990s to make it quicker, less complex and more efficient in light of the overall reductions in federal acquisition work force. To achieve the economies of scale and to address lack of resources in federal contracting agencies to oversee contracts awarded, the federal government began awarding larger contracts. By the late 1990s, the impacts of these changes were clearly seen in the small business community. Awarding only large contracts virtually ensures that small contractors will not be able to obtain these contracts since they do not have the capacity and capital necessary to complete the contract, and therefore, will not be able to provide the required bonds.

Small Contractor vs. Federal Agency Set Asides

All federal agencies have a goal that requires 23% of the total dollars awarded in government contracts to be given to small businesses. This ambitious goal combined with a stretched procurement workforce within the federal government leads to project opportunities that are set aside for small businesses, but are quite large. Contracting agencies argue that they do not have a sufficient number of contracting officers to manage a higher number of low-dollar projects. The high dollar value of some federal government construction projects make them impossible for a small contractor to undertake. (SFAA staff is aware of instances of small business construction project opportunities valued in excess of \$50 million.) Qualified small contractors that are “small” in accordance with the applicable regulations (up to \$33.5 million in revenues under the standard of the Small Business Administration (SBA)) can get bonding at some level, and could perform some of the work, but cannot obtain bonds at a high enough level to bid the project. There is a disconnect between the size of projects that are advertised to meet small business goals and the size of construction projects that the small contractor is qualified to perform.

Small Contractors vs. Road Blocks in Current Federal Regulations

Mentor/protégé programs and joint ventures with larger contractors could provide a means for small contractors to participate in public construction projects. The current regulations, however, lack clarity and standardization among the procuring agencies as to what arrangements are acceptable. In addition, the regulations present disincentives to participate in a joint venture with a larger contractor. For example, a small business could lose its qualification as a small business if it participates in a joint venture in which the joint venture partner does not qualify as a small business. Once an otherwise qualified small business loses its status, the small contractor cannot take advantage of the set-aside opportunity and the federal agency letting the construction contract faces an obstacle in meeting its small business participation goal.

What is Needed Now

It is time to restore some needed balance between two laudable goals of the federal government, namely, efficiency in procurement and involvement of small businesses in procurement. The federal agencies cannot afford to go back to the labor intensive system of the past nor can the agencies continue to pursue operational efficiencies at the expense of small businesses.

Small contractors that participate in joint venture and mentor/protégé programs should not lose their status as a qualified small business. The federal procurement rules need to be changed to permit small contractors to participate in federal work to the extent that they can and to permit federal agencies letting construction contracts to count the work that the small contractor self-performs towards their small participation goal. The regulations explicitly should permit open joint ventures between the small contractor and a larger contractor in any construction contracts of \$50 million or less. In any such joint venture between a small and large contractor, the small business should be required to self-perform at least 10% of the work in jobs between \$25--\$50 million and 15% of the work in jobs under \$25 million. Federal agencies letting construction contracts on this basis should be permitted to count some multiple of the small contractor's work (2 to 3 times the amount of work self-performed) towards their small participation goal.

The federal procurement rules also must contain mandates and incentives so that construction contracts are broken into smaller parts so that the truly small and emerging contractors in the industry--not participating in joint venture or mentoring programs—can participate in federal construction projects. The federal rules should require any federal agency letting construction contracts to let 5% of its total procurement budget in contracts of no more than \$5 million. These contracts would be part of the agency's federal small participation goals. Any contract under \$5 million in excess of this 5% requirement should be credited as \$5 million towards the agency's small participation goal, regardless of the actual dollar amount of the contract.

The challenge for this Congress is to strike the right balance among operational efficiency, opportunity and fairness.



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**Assigning Federal Construction Contracts
to Sureties Enhances Performance**

Background on Federal Surety Statute

The Miller Act, 40 U.S.C. §§3131 *et seq.*, requires performance and payment bonds in connection with all federal public works contracts in excess of \$100,000 to assure completion of construction on time and according to the specifications in the contract and payment of laborers, subcontractors and suppliers of material. If a contractor encounters financial problems during the job, its Miller Act surety is often called upon to finance completion of the bonded federal contract either directly by advancing money to the contractor or indirectly by paying the subcontractors and suppliers. Such financing helps to avoid performance problems and to avoid the delay and expense of a default.

Background on Federal Assignment of Claims Acts

The Assignment of Claims Acts, or Anti-assignment Acts, 31 U.S.C. §3727 and 41 U.S.C. §15, generally void any assignment of a government contract or a claim against the government. During World War II, Congress added certain enumerated exceptions to help contractors obtain financing. Unless the contract provides otherwise, a contractor is permitted to assign all payments remaining under the contract to a single assignee. Written notice of the assignment must be given to the government and the contractor's surety, and the assignee must be a "financing institution" or a "bank, trust company, or other financing institution, including any Federal lending agency." In interpreting the amendments, the courts have held that a Miller Act surety is not a "financing institution" eligible to receive a valid assignment so that contractors cannot assign their rights to funds under a federal construction project to their surety.

How Recent Case Law Interpretations Have Impacted Federal Surety Bonds

Until recently, this was not a practical problem because sureties had other ways to enforce their rights to contract funds. Since the Assignment of Claims Acts do not bar transfers allowed by operation of law, including the doctrine of subrogation, sureties that paid to complete bonded contracts still are entitled to receive the contract funds. When the contractor defaulted and the surety took over the work under its performance bond, the government and the surety usually entered into a takeover agreement, which provided that all funds due or to become due under the contract would be paid to the surety. If the contractor continued to perform, but did not pay its bills, thus obligating the surety to pay the subcontractors and suppliers under the payment bond, the case law entitled the surety to receive the contract funds. The surety, as a "contractor" under the agreement could contest any back-charges and dispute any claims.

In several recent cases, however, the courts have held that a surety which enters into a takeover agreement and completes a bonded construction project becomes a “contractor” only as to claims arising after the takeover agreement and is not entitled to prosecute any claims arising prior to its takeover of the work. Yet, the contractor in default often will have unresolved claims (change orders, extra work, differing site conditions, delays) pending at the time of the default. The surety stepping in to complete the job now cannot assert excusable delays to mitigate liquidated damages or make claims for equitable adjustments if the delays or claims arose prior to the surety’s takeover of the work. Only the defaulted contractor can prosecute these claims, and the contractor is usually out of business and has no incentive in any case to spend money on a claim, which will benefit only the surety. The contractor cannot assign the claims to the surety because of the way that the Assignment of Claims Acts has been interpreted to bar assignment to sureties. As the Court of Appeals for the Federal Circuit stated in 2002, if the statutory exemptions in these Acts are to be broadened, “it is for Congress, not the courts, to do so.”

These cases do not question or change the long-standing subrogation rights of the surety to receive payments due under a construction contract when the surety has paid claims under its payment or performance bonds. They hold that the party entitled to receive the payments, the surety, does not have standing to assert the claims essentially making the right unenforceable.

Why a Change in Federal Law is Needed to Permit Assignments to Sureties

The federal Assignment of Claims Acts should be changed to permit claims under federal contracts to be assigned to sureties as the court decisions interpreting it have misunderstood the role of the surety in providing financial assistance to a contractor that the surety has bonded to complete a job. Since the contractor is obligated to indemnify the surety for any claims paid under the surety bond, most contractors are happy to assign the surety any claims as part of the indemnification process under the bond or as an inducement to the surety to write the bond or provide financing during the project for the contractor’s performance. When a contractor experiences financial difficulty on a project, the surety’s assistance benefits the federal government as the project proceeds without interruption and without the need to terminate the contractor. A permitted assignment of claims to the surety in these circumstances also removes any future confusion, dispute and litigation as to who is entitled to receive government payments under the contract.

Without the ability to make an assignment of claims under a construction contract to a surety that has performed the work, the federal agencies may continue to pay the contractor, which provides the opportunity for the contractor to abscond with the money. If the contractor could make a formal assignment to the surety, these problems could be avoided.

This change in the law gives sureties parity with banks, which can be assignees under the Assignment of Claims Acts. Under the existing interpretation of the Acts, the bank that gave the contractor a loan to do the job can be an assignee, while the surety that provided the Miller Act bonds and gave the contractor a loan mid-term in the project to ensure its completion cannot be an assignee. It should be emphasized that the Assignment of Claims Acts permit only a single assignment of all the contract funds due under the contract. If a contractor has made an assignment to a financing institution and the government has been notified, a later assignment to

another party does not oust the first assignee. The ability to force the government to honor an assignment to a surety will benefit the surety only if the contractor has not already made another assignment under the contract.

Just as the relevant portions of the Assignment of Claims Acts were amended in the World War II era to help contractors working on war-related contracts get financing, amending the law to permit assignments of claims to sureties now is needed to respond to today's contracting realities.

In order to permit assignments to sureties financing performance of the contract work, we propose to amend the Assignment of Claims Acts as follows:

1. Amend paragraph (c) of 31 U.S.C. §3727 by inserting "surety on a bond provided in connection with the contract or other" before "financing institution" in the first sentence.
2. Amend paragraph (b) of 41 U.S.C. §15 by inserting "surety on a bond provided in connection with the contract" after "trust company" and before "or other financing institution" in the first sentence.



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McCarran-Ferguson Fosters a Financially Sound and Highly Competitive Insurance Industry

Congress is Considering Repeal of McCarran Ferguson

The insurance industry has a limited immunity from the federal antitrust law under the McCarran Ferguson Act of 1945 (McCarran). The purpose of McCarran is two-fold: 1) it returns to the states the authority to regulate the business of insurance and 2) it grants the business of insurance limited immunity from the federal antitrust laws to the extent that it is regulated by the states. In no event are any activities that constitute boycotts, coercion or intimidation shielded from antitrust enforcement. McCarran covers only collective insurance industry activities that are regulated by the states. It allows for sharing of data through advisory organizations to help all insurers assess risks but does not allow individual insurers to fix prices or otherwise restrain competition in the industry. Congress is considering legislation that repeals the McCarran limited immunity and allows federal agencies to regulate the business of insurance.

Repeal of McCarran Hurts Consumers and Small Businesses

McCarran allows for limited sharing of data in the insurance industry to help all insurers measure risk and price insurance products. This is particularly important for surety and fidelity insurance, which represents only 2% of the total property-casualty insurance market in the United States. Even the largest surety company likely would not have actuarially sound data on its own.

Without aggregate industry loss data, each insurer could inadvertently either over price or under price its product. Consumers do not benefit from being overcharged or buying insurance from an insurer with financial problems due to under pricing. McCarran has promoted a remarkably competitive insurance market with thousands of companies writing insurance with relatively little insolvency. Changing that is a bad idea.

If access to aggregated industry data was not protected, each individual company would have to bear the expense of compiling that data on its own. The costs would be prohibitive for many small- to medium-sized insurance companies that lack the resources to undertake these functions individually, and they would be particularly hard hit. Without the services of advisory organizations, small companies would not be able to compete with the large insurers as they do now in most markets. There would be fewer insurers in the market. Fewer insurers translates into less competition, and less competition translates into fewer choices for consumers and higher prices. Collective access to the services of advisory organizations helps small insurers stay in business. There are over 500 companies writing surety bonds in the United States. Many of these are small and regional companies without sufficient data to adequately price these bonds without reference to trade association aggregate data. These sureties provide bonds at a fair price to contractors who might not be of interest to other larger sureties. Changing that is a bad idea.

In the decades since McCarran was enacted, clear boundaries of permissible and illegal activities have been established for insurers, advisory organizations and the state insurance regulators that oversee them with an extensive array of state laws and regulations, as well as lengthy litigation. If McCarran is repealed, the industry will face protracted litigation regarding its collective activities under the federal antitrust laws. It will result in legal and regulatory confusion, which adds costs to the system that consumers will bear. The certainty of the current legal and regulatory structure promotes competition in the industry. Why change that?

McCarran Promotes Healthy Competition in the Insurance Industry

Insurance is a unique product. While most products can be priced when they are sold based on factors such as the cost of production and distribution, the true cost of insurance is unknown at the time of sale. It is a promise now to pay for losses that occur later. In order to price their products, insurers need aggregate loss data from the industry. To accurately predict the cost of future losses and price the insurance product accurately when it is sold, insurance actuaries combine historical loss data into statistically credible pooled databases, using generally accepted and tested actuarial techniques such as loss cost development and trending. Collective loss cost aggregation provides all insurers with much-needed statistical credibility in how to price its products. This allows more insurers to enter the market and to compete with large insurers. All of this protects consumers and enhances their insurance choices.

The combination of McCarran and state insurance regulation allows insurers to exchange critical data regarding losses, engage in data analysis and develop standardized policy forms through state licensed advisory organization such as The Surety & Fidelity Association of America (SFAA) and the Insurance Services Office (ISO). These organizations provide the complex, costly and time-consuming tasks of providing loss cost information and standard policy forms that few insurers would have the ability to undertake on their own. Each insurer benefits from the economies of scale in these services from advisory organizations, keeping the prices lower, and each insurer adds its own experience to the data and other services to set its own prices and coverage.

Standardized policy forms allow consumers to know that they are comparing similar insurance coverage when shopping for insurance. They may be quoted different prices and offered different services, but the coverage is standardized so that they have a common base to evaluate different insurers.

Advisory organizations are subject to state insurance regulation and most state insurance codes contain a list of permitted and prohibited activities for advisory organizations. State insurance departments examine advisory organizations for their compliance with state laws and regulations and for the quality and accuracy of the data that they report to state insurance departments.

Much of the effort to repeal McCarran is based on the belief that it allows individual insurers to collude on prices and policy coverage. It is illegal for insurers to act outside of the scope of the licensed and regulated advisory organizations or to restrain competition in any way. Rather than increasing competition, repeal of McCarran would likely decrease the number of insurers competing in the marketplace, increase insurance costs and reduce the availability of many insurance coverages including surety and fidelity bonds.



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An Introduction to Surety Bonds

Surety Bonds: A Unique Form of Insurance

A surety is traditionally defined as one who contracts to answer for the debt or default of another. Sureties today are almost always insurance companies; and, under most state laws, surety bonds are insurance, subject to state insurance regulation. Surety is, however, a unique type of insurance governed by different principles from other property-casualty lines. What makes surety bonds different is that the underwriting inherently relies on credit principles. It also is important to recognize that the objective of surety bonding is not only to provide indemnity but also to pre-qualify the bond applicant, thus reducing the possibility of loss to the general public.

Two vs. Three Party Contracts

A typical insurance policy involves two parties: the insured and the insurer. A surety bond involves three parties:

- 1) **The Principal** (the applicant on whose behalf the bond has been issued and whose potential non-performance or default is the subject of the bond);
- 2) **The Obligee** (the party to whom the debt or obligation of the principal runs and who is protected by the surety bond); and
- 3) **The Surety** (the guarantor of the principal's performance).

Spreading Losses vs. Pre-qualifying Risks

An insurer spreads the risk of fortuitous losses over a group exposed to them. The insurer expects that a certain percentage of its insureds will suffer a loss during the policy period, and premiums are set accordingly. Surety underwriting is based on the financial and technical capability of the surety to evaluate risks to prevent any losses. While losses certainly occur, the surety does not underwrite a bond expecting a loss. If the surety believes there is an appreciable likelihood that a principal cannot perform its obligations, the surety should not write the bond. The surety provides the obligee with pre-qualification of principals who will pay or perform as promised to the obligee.

Claims and Indemnity

A typical insurance policy is purchased by the insured to provide coverage against specified losses. If these losses occur, the insurer compensates the insured, and the insurer has no recourse against the insured. The obligee requests the surety bond to guarantee against the principal's failure to perform its obligation to the obligee. Although the principal has the burden of

obtaining the bond, it directly protects the obligee(s), not the principal. If the principal fails to perform, the surety will perform, but the surety will seek reimbursement from the principal. The surety suffers a loss only if the principal fails to perform its obligations and is financially unable to reimburse the surety.

Mandatory vs. Voluntary Coverage

State or federal law mandates most contract and commercial surety coverages. The obligee is required by law to demand such coverage from the principal. Most other property-casualty coverage is sold in the voluntary market.



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The Three Basic Types of Bonds

Elements of Suretyship. Suretyship is a specialized line of insurance in which one party guarantees performance of an obligation owed by another party. There are three parties to the agreement:

The principal (undertakes obligation).

The surety (guarantees the obligation's performance).

The obligee (receives the benefit of the bond).

The Bond. A surety bond is a written agreement under which the surety promises to answer for the principal's default. A key element of suretyship is the fact that the surety is entitled to reimbursement from the principal for the surety's losses.

I. Contract Surety

These are the bonds that the general contractor is required to provide under state and federal law on public construction projects to assure that they are completed on time and according to the specifications and to assure that certain subcontractors and suppliers who provided materials and labor will be paid. The three key bonds are:

- **Bid Bonds**—These bonds provide financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the price bid and provide the required payment and performance bonds.
- **Performance Bonds**—These bonds protect taxpayers against financial loss should the contractor default or fail to complete the job according to the terms and conditions of the contract.
- **Payment Bonds**—These bonds guarantee that the contractor will pay certain laborers, material suppliers and subcontractors associated with the project.

II. Commercial Surety

There are basically five major categories of commercial surety bonds that are required under state and federal laws:

- **License and Permit Bonds**—This is any bond required by state law or regulation as a condition precedent to issuing a license to engage in a particular business or permit to engage in specified activity or privilege. The bond guarantees that the licensee or permit holder will comply with state laws and regulations and indemnifies against specified losses from non-compliance.

Typical license and permit bonds include: *contractors' license bonds; motor vehicle dealer bonds; payroll processor bonds; securities dealers' blue sky bonds; mortgage broker bonds; employment agency bonds; health spa bonds; grain warehouse bonds; liquor and cigarette tax bonds; and sales tax bonds.*

- **Judicial Bonds**—Those who avail themselves of the protections and remedies that are allowed by law through the court system often are required to furnish a bond to protect the opposing party or other interested parties and property.

Typical judicial bonds include: *appeal bonds/supersedeas bonds; injunction bonds; tax or other refund bonds; and discharge of mechanics lien bonds.*

- **Fiduciary Bonds**—A fiduciary is a person, bank or trust company appointed by order of a court to administer the estate, property or other affairs of another person who, for some reason, is unable to manage his or her own affairs. Fiduciaries generally are required by law to provide the court with surety bonds to assure their faithful performance of court-ordered duties.

Typical fiduciary bonds include: *administrator bonds; bankruptcy trustee bonds; executor bonds; and guardian bonds.*

- **Public Official Bonds**—This type of bond guarantees the faithful performance of duty by a public official in a position of trust. Such bonds are given to assure compliance with statutes and whatever liability the applicable statutes impose. These bonds protect the public against loss from non-compliance and do not provide any indemnity for the public official.

Typical public official bonds include: *treasurer bonds; tax collector bonds; sheriff bonds; notary bonds; and court clerk bonds.*

- **Miscellaneous Bonds**—While these bonds do not fit neatly into any other category, they bond many significant functions and duties.

Miscellaneous bonds include: *lease bonds; workers compensation self-insurance bonds; lost securities bonds; and union wage and welfare bonds.*

III. Fidelity

A fidelity bond is a bond that indemnifies the insured for losses caused by the dishonest acts of its covered employees. In addition, a fidelity bond typically covers the insured against the following:

- Forgery or alterations;
- Loss inside the premises cause by theft, disappearance and destruction, and robbery and safe burglary;
- Loss outside the premises caused by the robbery of a messenger.

These coverages sometimes are referred to as crime coverage. Fidelity bonds are divided into two major categories, based on the type of institution purchasing them: 1) financial institutions (brokers, insurance companies, and banks) and 2) mercantile and governmental institutions (non-financial institutions).