



# The Surety & Fidelity Association of America

100 Years of Service: 1908-2008

## Primer on Surety Law

Suretyship has been practiced for at least 5,000 years and is one of the oldest societal and commercial relationships. More than 1,000 years before the birth of Christ, King Solomon admonished: “he that is surety for a stranger shall smart for it.”<sup>1</sup>

A surety bond is a three-party contract in which the surety guarantees that the principal/obligor will perform its obligations to a third party, the obligee. Under a performance or payment bond, the principal is a construction contractor, and the surety guarantees that the contractor will complete the work and pay its obligations, and often the obligations of its subcontractors. The contractor, however, remains primarily liable, as the surety is a guarantor and is entitled to indemnity from the contractor for any payment.

In a case of a contract awarded by a state department of transportation (DOT) to build and repair roads, for example, the winning contractor is required by law to procure a bond for the protection of the state DOT, and the contractors’ subcontractors and suppliers. The principal in this example is the contractor who is awarded the contract, the obligee is the state DOT, and the surety is the entity that issued the payment bond or performance bond to guarantee the contractor’s performance and payment to the principal.

The same relationship exists in private contracts. Where a private owner desires to construct a building, awards the contract for construction of the building to a contractor, and requires the contractor to procure a performance bond and payment bond, the contractor is the principal under the performance and payment bonds, the obligee under the performance and payment bonds is the owner, and the surety is the entity which issues the bonds together with the principal.

In the government contract context, performance bonds are required to ensure that the contractor completes the project for the governmental entity and the payment bonds are designed to provide protection to the subcontractors and suppliers of the contractor in the event that it fails to make payment. Bonds are used in private contracting context for similar reasons.

---

<sup>1</sup> Proverbs 11:15.

## **Insurance Policies vs. Surety Bonds---A Comparison**

Surety is insurance but it is a unique form of insurance. An insurance policy shifts the risk of loss to the insurer. The insurer is primarily obligated to pay any valid claim, and it has no recourse against the insured to recover its loss. The insurer handles the claim and pays with its own money. Under a surety bond, on the other hand, the surety is entitled to indemnity from the principal and pays with the principal's money. The principal, therefore, has a vital interest in resolution of the claim.

In a claim situation, the principal may insist that the surety should not pay the claim. Upon investigation, the surety often finds that there is a legitimate dispute between the principal and the claimant. If the surety pays the claim over the principal's objection, it effectively forecloses the principal's opportunity to assert its side of the dispute with the claimant.

Insurance policies are typically contracts of adhesion drafted by the insurer. Bonds are typically drafted or selected by the obligee. The one-sided contract and unequal bargaining power often encountered in insurance claims simply does not exist in the context of surety bonds. As the party requiring the bond and mandating the form it will take, the obligee can include whatever rights it wants, including attorneys' fees or deadlines for payment of claims. Of course, if the obligee makes the terms too onerous, the principal and surety can refuse to provide the bond. Bonds are commercial contracts bargained for between commercial entities well able to protect themselves.