

MICROFILM DIVIDER

OMB/RECORDS MANAGEMENT DIVISION
SFN 2053 (2/85) 5M



ROLL NUMBER

DESCRIPTION

2279

2005 SENATE AGRICULTURE

SB 2279

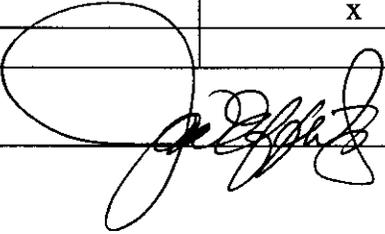
2005 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB 2279

Senate Agriculture Committee

Conference Committee

Hearing Date February 3, 2005

Tape Number	Side A	Side B	Meter #
1	x		3613 - end
1		x	0 - 885
Committee Clerk Signature 			

Minutes:

Chairman Flakoll opened the hearing on SB 2279, a bill relating to a bonding fund for auctioneers and grain warehousemen; relating to a joinder of a surety and to provide a continuing appropriation. All members were present.

Senator Klein introduced the bill. During the interim with the Public Services Committee, there was discussion about whether the state could be a source of bonding for auctioneers and grain warehousemen to create another service and opportunity. A lot of information indicated the bonds were difficult to get and not very many companies offered the bonds. The fiscal note shows it provides tremendous income, after the tremendous expense.

There was no testimony in favor of the bill.

Steve Strege, North Dakota Grain Dealers Association, testified in opposition to the bill. (meter 3982) (written testimony)

Senator Klein asked if it would matter if it was the Public Service Commission or the State Bonding Pool running the bonding. Would you prefer to keep it on the private side and leave the government out of it. (meter 4493)

Mr. Strege said yes.

Senator Taylor asked if most grain elevators go through CNA Surety.

Mr. Strege said they write through CNA Surety. There are a number of other companies. It is kind of a specialty market.

Senator Taylor asked if the bill said "may" rather than "must" would that affect your opinion.

Mr. Strege said that would be less intrusive. They would want it to be based on the same economic principals. There are some people who shouldn't have a grain warehouse bond. There is a reason they aren't easy to get.

Senator Klein asked where CNA is located.

Mr. Strege said the person they work with is out of Minneapolis. They have many subsidiaries. Todd Kranda, CNA Surety, testified in opposition to the bill. (written testimony) (meter 4994)

Senator Flakoll asked if some people have trouble getting the pre qualification.

Mr. Kranda said yes, if you are not qualified, you shouldn't be in the business. He is not aware of any serious problems.

Senator Klein said one of the issues is the smaller warehouseman have to match dollar for dollar for the bonds. Isn't more of the risk with the larger warehouseman. Is there only one example of a state recovery fund that was more restrictive and slow to recover. Is that the only example.

Mr. Kranda said the state he referred to was Louisiana. He doesn't know of others.

Senator Klein said you implied the Public Service Commission would be slow. Currently, they do a tremendous job and could be assumed to do the same with new responsibilities.

Mr. Kranda said he did not mean to imply the Public Service Commission would be slow. This would be a whole new program for them. The learning curve is there.

Senator Klein said they do a lot of things right. He wasn't thinking of the Public Service Commission to regulate this, he was thinking of the State Bonding Pool.

Mr. Kranda said this would be an additional burden and a new area.

Mark Dougherty, Associated General Contractors of North Dakota, testified in opposition to the bill. Contractors use bonds on a regular basis. On principal, they are against the state competing with private industry. 21 companies offer this type of bonding in North Dakota.

David Strehle, North Dakota Chamber of Commerce, testified in opposition to the bill. (meter 11, side B, tape 1) Private industry is filling this need.

Senator Klein asked if he would be opposed to having a pool of money that would reduce premiums to your membership.

Mr. Strehle said private industry can do it in a cost effective manner. He doesn't think the state could do it for less.

Senator Klein said there have been \$10 million in premiums spent vs. the \$3 million paid out. They are doing well. That is what started the discussion.

Mr. Strehle said he understands. If a person is unhappy with their premiums, perhaps they should try another company.

Sue Richter, Director of the Licensing Division of the Public Service Commission testified in a neutral position. (written testimony) (meter 222)

Page 4

Senate Agriculture Committee
Bill/Resolution Number SB 2279
Hearing Date February 3, 2005

Mr. Strege said in reference to the size of the bond for grain warehousemen, the bond requirements are in law. Smaller elevators have larger bonds proportionately. If there is a bond loss, you will lose the first dollars on the bond. The likelihood of losing more at the top end is less. The levels of bonds were brought down about 4 years ago when the feds say we couldn't require bonding of federally licensed elevators. The level of bonds were brought down to keep more elevators in the state system.

Chairman Flakoll closed the hearing on SB 2279. (meter 746)

Senator Taylor moved a do not pass on SB 2279.

Senator Erbele seconded the motion.

The motion carried on a roll call vote 6-0-0. **Senator Klein** will carry the bill.

FISCAL NOTE

Requested by Legislative Council
01/19/2005

Bill/Resolution No.: SB 2279

1A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2003-2005 Biennium		2005-2007 Biennium		2007-2009 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues	\$0	\$0	\$0	\$3,034,200	\$0	\$3,034,200
Expenditures	\$0	\$0	\$2,859,250	\$3,034,200	\$2,154,100	\$3,034,200
Appropriations	\$0	\$0	\$2,859,150	\$3,034,200	\$2,154,100	\$3,034,200

1B. **County, city, and school district fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

2003-2005 Biennium			2005-2007 Biennium			2007-2009 Biennium		
Counties	Cities	School Districts	Counties	Cities	School Districts	Counties	Cities	School Districts
\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0

2. **Narrative:** *Identify the aspects of the measure which cause fiscal impact and include any comments relevant to your analysis.*

Several aspects of this bill cause fiscal impact. The bill asks the Commission to act as a surety in selling bonds to grain warehousemen, auctioneers and auction clerks. Revenues from the sale of these bonds will cause fiscal impact. Implementing the process and continuing administration will cause fiscal impact due to the need for additional staff with special expertise. Additionally, funds will be necessary to provide protection against claim payments, at least until there are sufficient funds from premiums. Finally, if a warehouseman becomes insolvent or a claim is made against an auctioneer or auction clerk bond, the payment of claims will cause fiscal impact.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*

A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

Revenues to the special fund will come from premiums paid by grain warehousemen, auctioneers and auction clerks, plus an amount from the general fund. We project annual premiums for grain warehousemen will total \$670,850 and yearly premiums for auctioneers and auction clerks will total \$34,200. The current total bond liability of all public warehouse licensees is \$67,085,000. We estimate premiums at 1% of \$67,085,000 or \$670,850. We have used the 1% of total liability for auctioneers and auction clerks as well. The current total bond liability of all auctioneer and auction clerks is \$3,420,000. Assessing a 1% premium would equal \$34,200. Total estimated annual revenue from premiums would be \$705,050. We do not estimate any revenue until 2006, because it would take at least a year to get the program up and running. Consequently, the premium revenue estimate for 2005-2007 is \$705,050 and for the 2007-2009 biennium is twice that or 1,410,100.

Because the bill creates a special fund for these bond premiums, the impact of this revenue is shown as revenue to other funds, not the general fund. In addition, we assume the intent of the legislation is to pay valid claims from this special fund. We believe that the special fund, then, should have sufficient starting money to cover potential claims until premiums become sufficient to pay claims. We estimate needing seed money of \$3,000,000 for the grain warehouse fund and \$34,200 for the auctioneer/auction clerk fund, for a total need of \$3,034,200. The difference between this amount and the expected revenue from premiums for the 2005-2007 biennium is \$2,329,150, which will be additional revenue to other funds, as well as an expenditure to the general fund. Consequently, total special fund revenue for each biennium is the estimated premiums received plus the amount of general fund seed money needed

to bring the fund up to a sufficient level to cover potential valid claims.

B. Expenditures: *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

The bill will cause several types of expenditures. Implementation and administration of the program will cause expenditures for salaries and operating expenses. We assume these will be general fund expenditures because the premiums paid into the fund will be insufficient to cover potential insolvencies and claims, and trying to cover salaries and operating expenses, as well, will just make matters worse. We have estimated that this program will require a minimum of \$380,000 in salaries and benefits for a biennium. This is made up of two new auditor FTEs (at \$60,000 annual expense each), one new inspector FTE (at \$53,000 annual expense) and one-half administrative support FTE (at \$17,000 annual expense) for a total annual salary line item expense of \$190,000, or \$380,000 for a biennium. These positions will be needed because of the functions involved in determining whether any particular licensee qualifies and continues to qualify for the required bond. These positions will involve, among other functions, auditing the financial condition of licensees on a continuing basis, which is not a function currently performed by the Commission. The Commission also estimates the need for an additional \$150,000 per biennium for operating expenses associated with implementation and administration of the program. These costs include software for the audit and bonding functions, legal fees, professional fees, IT support and equipment, travel, training and other general operating expenses. Total general fund expenditures for a biennium are estimated at \$530,000.

A question arises regarding the funds necessary should an insolvency occur before the premiums taken in by the fund are sufficient to cover the amount needed to pay valid claims. We are assuming the legislature intended that the fund be sufficient to cover claims and we estimate this need at \$3,000,000 for the grain warehouse fund and \$34,200 for the auctioneer/auction clerk fund, for a total need of \$3,034,200. The special fund premium revenues will not be sufficient in either biennium to reach this amount and so general fund monies will be needed to bring the fund up to a sufficient level. In the 2005-2007 biennium, we estimate this general fund amount to be \$2,329,150 (\$3,034,200 less \$705,050) and in the 2007-2009 biennium, we estimate this general fund amount to be \$1,624,100 (\$3,034,200 less premium revenue of \$1,410,100). The general fund expenditures for each biennium are the totals of the amounts needed as seed money plus the amounts needed for salaries and operating expenses. For the 2005-2007 biennium this totals \$2,859,250 and for the 2007-2009 biennium this totals \$2,154,100.

Special fund expenditure amounts are estimated equal to the amounts we believe are necessary to pay valid claims in the event the Commission must proceed against a licensee's bond.

C. Appropriations: *Explain the appropriation amounts. Provide detail, when appropriate, of the effect on the biennial appropriation for each agency and fund affected and any amounts included in the executive budget. Indicate the relationship between the amounts shown for expenditures and appropriations.*

An appropriation would be required for the general fund expenditures estimated above.

A question arises regarding the funds necessary should an insolvency occur or claim be made before the premiums taken in by the fund are sufficient to cover the amount needed to pay valid claims. We are assuming the legislature intended that the fund be sufficient to cover insolvency claims and we estimate this need at \$3,000,000 for the grain warehouse fund and \$34,200 for the auctioneer/auction clerk fund, for a total need of \$3,034,200. The special fund premium revenues will not be sufficient in either biennium to reach this amount and so general fund monies will be needed to bring the fund up to a sufficient level. In the 2005-2007 biennium, we estimate this general fund amount to be \$2,329,150 (\$3,034,200 less \$705,050) and in the 2007-2009 biennium, we estimate this general fund amount to be \$1,624,100 (\$3,034,200 less premium revenue of \$1,410,100). The general fund expenditures for each biennium are the totals of the amounts needed as seed money plus the amounts needed for salaries and operating expenses. For the 2005-2007 biennium this totals \$2,859,250 and for the 2007-2009 biennium this totals \$2,154,100.

An appropriation will be necessary for the general fund expenditures, including the additional FTEs.

A special fund appropriation may not be necessary, since the bill contains a continuing appropriation. However, we have included it here under the appropriation box, above, so the need for spending authority, and the amount, is clear.

Name:	Ilona Jeffcoat-Sacco	Agency:	PSC
Phone Number:	701-328-2400	Date Prepared:	01/31/2005

REPORT OF STANDING COMMITTEE (410)
February 3, 2005 1:50 p.m.

Module No: SR-22-1776
Carrier: Klein
Insert LC: . Title: .

REPORT OF STANDING COMMITTEE

SB 2279: Agriculture Committee (Sen. Flakoll, Chairman) recommends DO NOT PASS
(6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). SB 2279 was placed on the
Eleventh order on the calendar.

2005 TESTIMONY

SB 2279



NORTH DAKOTA GRAIN DEALERS ASSOCIATION

STEVEN D. STREGE, Executive Vice President
CHERYAL WELLE, Executive Assistant
CONNIE LEIER, Administrative Assistant
Ph: 701-235-4184, Fax: 701-235-1026
118 Broadway, 606 Black Bldg., Fargo, ND 58102
Website: www.ndgda.org

STU LETCHER, Safety & Health Director
Ph: 701-543-3110, Fax: 701-543-4183
P.O. Box 72, Hatton, ND 58240

HAL GRIEVE, Safety Specialist
Ph: 701-633-5256, Fax: 701-633-5258
204 4th Avenue S., Buffalo, ND 58011

TO THE SENATE AGRICULTURE COMMITTEE - FEBRUARY 3, 2005
SENATOR TIM FLAKOLL CHAIRMAN
TESTIMONY OF NORTH DAKOTA GRAIN DEALERS ASSOCIATION
RE: SENATE BILL 2279 - STATE BONDING FUND

Good morning Mr. Chairman and members of the Senate Ag Committee. My name is Steve Strege. I serve as Executive Vice President of the North Dakota Grain Dealers Association. We are a 94-year-old voluntary membership trade association and over 90% of our state's grain elevators are members. With great respect for sponsors Senator Klein and you Mr. Chairman, we are nevertheless here in opposition to SB 2279.

This bill takes a private sector function, that has been working quite well we feel, and creates more government to deal with it. We don't agree with that concept.

In a more practical sense, surety companies that write bonds have experience doing it; the Public Service Commission does not. Why fix something that's not broken?

Another concern we have is the confidentiality of private elevators' financial statements. Cooperatives publish theirs to members, but even then the nitty gritty details are usually reviewed by only the board. Sole proprietorships and closed corporations probably don't want their financial reports in the hands of a government agency where open records laws might apply.

The North Dakota Grain Dealers Association has been an agent for writing warehouse bonds since back in the early part of the last century. I think we do a good job of it, and the loyalty of our clients confirms that. My predecessor told me that the Association got into this service because warehouse bonds were difficult to obtain, and that by pooling a book of business we acquired a steady source, better

deals and more favorable underwriting. That continues to this day. The company we write with, CNA Surety, bonds some top-of-the-line firms and some with less financial wherewithal. Over the years some elevators move from one category to the other. CNA writes the good, along with some of the not-the-best.

Bond underwriters are familiar with what a going concern grain elevator's financial statement should look like. They know about grain assets, storage liabilities, necessary working capital, contract positions, futures market positions, and more. Bond agents and underwriters monitor the financials of their clients. Some need more frequent and closer watching than others. Some of our clients are on an annual reporting basis, some semi-annual, some quarterly. Should the state get into this gathering and review process? We think not. Bonding through surety companies in the private sector has saved this state and its farmers' money by providing a financial screen through which only worthy applicants pass and get a license. Decisions are based on economics. With a state fund the possibility exists of politics entering the decision process.

On Monday of this week my garage door opener quit. It was growling, but the door wasn't moving. I could have spent a half-day or more researching the problem, getting the part, and putting it back together – maybe. I might have lost my religion in the process or fallen off the ladder. Instead I called a professional. He took it apart while it was still on the track, replaced a stripped gear, and was done in 30 minutes. The same principle applies in the warehouse bond business. There are professionals at this who know what they're doing, do it right, but because it's not extraordinary, this often goes unnoticed.

Are there people who can't get bonds or have difficulty? Yes, of course. You probably wouldn't want to see in the grain business most of those that don't qualify. Some of them have called me. When I start talking about net worth equal to the bond amount, or working capital of \$100,000 or \$200,000 they realize that getting a bond and license and being in the grain business isn't as easy as they had thought.

The North Dakota warehouseman's bond is based on storage capacity. It is basically 50¢ per bushel up to a \$250,000 bond for a 500,000-bushel elevator, and then an additional \$5,000 in bond for each 25,000 additional bushels. This is per company, not per location. The theory is that there will be grain assets to cover some of the obligations, and that has proven to be true. Here are examples and cost through us.

Up to a 100,000-bushel operation - \$50,000 bond minimum - cost \$563.

500,000-bushel operation - \$250,000 bond - cost \$2400

At this point the reduced bond per bushel kicks in.

1,000,000-bushel operation - \$350,000 bond - cost \$3250

2,000,000 bushel-operation - \$550,000 bond - cost \$4800

As the size of bond increases the premium per unit of coverage decreases. The average premium per company that we write is \$2470. There are currently 206 companies operating public grain elevators in the state.

These premium dollars do not accumulate in some pot of gold under the control of a bonding company. Agencies like the North Dakota Grain Dealers Association agency get a commission to cover personnel and other related expenses. Underwriters and their clerical staffs cost money. Some home office expense of these insurance companies is allocated against this business. These same expenses would be there for the state. Theoretically a bond is written without any prospect for loss. Supposedly the underwriting is tight enough so there will never be a loss. But losses occur. Many \$2400 bond premiums must be collected to make up for one \$250,000 loss, plus the expenses of getting and keeping the business, and claims handling expense.

We think the bonding function is being handled quite well by the private sector, at reasonable cost, and we urge a do not pass on this bill.

Thank you. I'll try to respond to any questions.

**Testimony in Opposition to
SENATE BILL NO. 2279
Senate Agriculture Committee
February 3, 2005**

Chairman Flakoll, and Senate Agriculture Committee members, my name is Todd D. Kranda. I am an attorney with the Kelsch Law Firm in Mandan and I appear before you today as a lobbyist on behalf of CNA Surety also known as Western Surety Company to express our concern and opposition to SB 2279.

SB 2279 is an attempt to establish a state bonding fund for auctioneers and auction clerks as well as for grain warehousemen. CNA is concerned about the bonding fund that is being created for auctioneers and auction clerks. CNA has been in business for 104 years and is presently providing surety bonds for auctioneers and auction clerks and for grain warehousemen in North Dakota. CNA has 250 plus independent agents in North Dakota who would be affected by SB 2279.

Several reasons exist why a state operated recovery fund such as is being suggested in SB 2279 for auctioneers and auction clerks and grain warehousemen should not be implemented to replace corporate surety bonds.

Attached for your review and reference is an outline entitled "The Case Against Recovery Funds" which identifies and summarizes the various reasons why a recovery fund such as is being suggested in SB 2279 should not be implemented to replace corporate surety bonds. I would like to highlight a few of the concerns that are identified on the attachment.

Accordingly, CNA opposes SB 2279 and urges a Do Not Pass recommendation.

THE CASE AGAINST RECOVERY FUNDS

The purpose of a surety bond is to protect public and private interests against financial loss.

A recovery fund is a government created entity that puts the state in the surety business. Fees are assessed against a chosen industry as a means of collecting revenue for the recovery fund. This revenue goes into a pool to cover claims (for problems) filed by consumers against members of that particular industry. Neither the state nor its consumers are well served when recovery funds are created to replace corporate surety bonds.

There are a number of reasons why recovery funds should not replace corporate surety bonds.

- In its simplest form, a state recovery fund infringes upon the basic principles of America's free market economy. It puts the state into the fidelity and surety business.
- Recovery from a state fund is more restrictive and difficult than recovery from a corporate surety.
- Most recovery funds require that the consumer obtain judgments and exhaust all civil and administrative remedies before submitting a claim against the fund.
- Bond companies are bound by statutes which require timely and good faith claims handling.
- In some cases, state funds have been too liberal in their payment of claims. The resulting problem is evident – the fund becomes insolvent. When that happens, the state or the licensees must make up the difference, or consumers must go without recovery.

Rather than serving as a source for generating income, a recovery fund actually may draw on the state's reserves. A state fund lowers the tax revenue of the state by the amount of premium taxes and other taxes which corporate sureties normally pay on these bonds. The state must employ additional staff to keep records of payments and investments of the funds. These employees also must process claims filed against the fund. The additional staffing expense must either be charged to the fund or come out of the state's general revenues. In the event of a shortfall, the state most often makes up the shortfall out of its general fund.

Surety companies provide the invaluable service of prescreening all applicants. One of the main purposes of requiring a surety bond is to gain the benefit of pre-qualification. In the absence of prescreening, more people who are financially or otherwise unqualified are allowed into the regulated business. This causes more problems for the public, and would constitute a drain on the assets of any newly established state recovery fund.

Surety companies have a long history of separating illegitimate claims from the valid ones and insuring that the requested dollar amount is realistic. There is no way a state fund could achieve this same efficiency without substantial, additional help.

The bottom line is that recovery funds attempt to provide the same services which corporate sureties have efficiently provided for decades in America. Previous experience indicates these funds ultimately cost the state money and are not efficient or fair to the consumer.

S. B. 2279

Presented by: Sue Richter, Director
Licensing Division
Public Service Commission

Before: Agriculture Committee
Honorable Tim Flakoll, Chairman

Date: 3 February 2005

TESTIMONY

Chairman and committee members, my name is Sue Richter. I am the Director of the Licensing Division of the Public Service Commission. The Licensing Division administers the Commission's jurisdiction over auctioneers and grain warehouses in North Dakota. The Commission asked me to appear here today to testify on Senate Bill 2279.

The Commission will create and administer the grain warehouse and auctioneer and auction clerk bonding funds if the legislature determines that is the appropriate way to address this policy issue. However, there are a number of general and technical problems with the bill which we want to bring to your attention. We would be happy to work with the sponsors, committee members and other interested parties to craft amendments to correct these difficulties and improve the bill.

Following are our concerns with this bill:

- The Commission does not have the resources to create and administer these proposed bonding funds.
- The single most important function required by this bill is the continual auditing of each licensee's financial condition. The Commission has no

staff with the expertise required to audit the financial condition of public warehousemen, auctioneers or auction clerks.

- The Commission has no expertise in designing the financial audit program that will be necessary to administer the program.
- It may be difficult, and it will definitely be expensive, to hire employees with the necessary expertise to design and implement the audit program.
- The Commission does not have the resources or expertise to design software to manage the program.
- The Commission may not be able to purchase off-the-shelf software to implement the program and customized software could be very costly.
- The Commission is concerned that the transition to the new program will be a burden to grain warehousemen, auctioneers and auction clerks.
- A licensee would lose the opportunity to obtain a bond and insurance from the same source, possibly resulting in the loss of discounts.
- We have no experience in determining bond premiums. In addition to the loss of discounts, our proposed rate may result in higher premiums for many licensees.
- Sureties may ask for collateral or some other form of guarantee, such as a letter of credit, when providing bond coverage. The bill provides no specific statutory authority enabling the Commission to require such guarantees and no specific authority to enforce them.
- The bill eliminates one of the options available to a licensee when a bond is canceled, because a replacement surety bond is no longer one of the available alternatives.
- The law is unclear regarding the Commission's authority to refuse to issue a bond to an applicant, even if that applicant is a bad risk.

- The six year statute of limitations for claims arising under a bond provides for a continuing exposure to the state.
- The Commission has no ability to actuarially estimate losses in order to determine appropriate funding levels.
- The bill does not authorize the Commission to require subrogation by an applicant, which offers an incentive for a rogue business person to become licensed and take advantage of the fund.
- The financial information obtained by the Commission on licensees would be open record.
- **Section 1** – erroneously removes the cancellation provision for auctioneer and auction clerk bonds.
- **Section 3** - erroneously requires the Commission to send itself a bond cancellation notice.
- **Section 3** – erroneously removes the language “run to the state of North Dakota.” This bill should include language identifying the obligation of the instrument which will run to the state of North Dakota.
- **Section 5** – erroneously removes the language referencing the warehouseman’s bond and does not include the Commission’s bond as a trust asset.
- **Section 6** – erroneously removes language providing the authority to join the suitable substitute for a bond if this section is repealed.
- Throughout the bill, the term “surety” is used inconsistently, and deleted inconsistently, yet this term is crucial to the purpose of the bill and whether the state is guaranteeing the obligations secured by the bond.

This completes my testimony. I would be happy to answer any questions you may have.

SB
7279

Suretyship

A practical guide to Surety Bonding

This publication furnished by CNA Surety,
Sioux Falls, South Dakota 57104.

<http://www.cnasurety.com>

©Copyright WSCo. 2004. All rights Reserved.

The Surety Bond: A Primer

Although surety is an ancient concept, its prime mission can be stated simply: performing a service for qualified individuals whose affairs require a guarantor.

In the United States, surety guarantees have been issued by corporations for over a century. These corporate sureties are large financial institutions. They have the necessary capital to make numerous commitments in the form of surety bonds.

Because insurance companies issue many surety bonds, some people think that insurance and surety bonds are the same thing. While there are similarities, there are also major differences.

What is a Surety Bond?

A bond guarantees the performance of a contract or other obligation. Bonds are *three party instruments* by which one party guarantees or promises a second party the successful performance of a third party.

1. The Surety--Is usually a corporation which determines if an applicant (principal) is qualified to be bonded for the performance of some act or service. If so, the surety issues the bond. If the bonded individual does not perform as promised, the surety performs the obligation or pays for any damages.

2. The Principal--Is an individual, partnership, or corporation who offers an action or service and is required to post a bond. Once bonded, the surety guarantees that he will perform as promised.

3. The Obligee--Is an individual, partnership, corporation, or a government entity which requires the guarantee that an action or service will be performed. If not properly performed, the surety pays the obligee for any damages or fulfills the obligation.

The example below illustrates how a surety bond works:

Joe, the principal, has promised someone (the obligee) that he will do something. If Joe fails to perform as he has promised, financial loss could result to that person.

Consequently, the obligee says to Joe, "If you can be bonded, I'll accept your performance promise." Joe goes to a surety and asks to be bonded.

After the surety is satisfied that Joe is qualified and will live up to his promise, it issues the bond and charges Joe a "premium" for putting its name behind Joe's promise.

Joe is still responsible to perform as promised. The surety is responsible only in the event that Joe does not fulfill his promises.

The Surety's Job: Protection

The purpose of a surety is to protect public and private interests against financial loss.

Therefore, the surety bonding company *must* be profitable and *must* have a strong balance sheet. No one is likely to accept the guarantee of a party with a bad name or a weak balance sheet. The surety bonding company guarantees performance. Its good name and its balance sheet back up that guarantee.

Probate bonds, notary public bonds, court bonds, license and permit bonds and public official bonds all guarantee protection of public interests from financial loss.

Why has corporate surety become such a vital part of doing business in today's economic society? Because there is no practical alternative for protecting public and private interests from financial loss.

Some Differences between Surety and Insurance

Although surety companies are often regulated by state insurance departments, surety bonding is different from insurance in some ways.

Several Differences

Insurance is a risk sharing device. It assumes that there will be losses. The expected losses are calculated by actuaries. These losses, coupled with anticipated overhead and other expenses, form the basis for the premium.

Surety is not actuarially rated as is insurance. Both insurance and surety call their fee a "premium." The surety's premium is as much a service charge as a conventional premium, which is determined on the basis of actual or anticipated losses. It is based largely on the cost of investigating the applicant and handling the transaction.

Surety: A Form of Credit

Surety is as much like banking as insurance. Bankers extend credit in the form of dollars loaned or as a commitment to loan. Every banker granting a loan fully expects to have the loan repaid. He investigates the borrower in sufficient detail to assure that such will be the case. Surety underwriters proceed in the same way.

SURETYSHIP vs. INSURANCE

Three party agreement. Most surety bonds are three party agreements. The surety guarantees the faithful performance of the principal to the obligee.

Two party agreement. Insurance is basically a two party agreement whereby the insurance company agrees to pay the insured directly for losses incurred.

Losses not expected. Though some losses do occur, surety premiums do not contain large provisions for loss payment. The surety takes only those risks which its underwriting experience indicates are safe. This service is for qualified individuals or businesses whose affairs require a guarantor.

Losses expected. Losses are expected. Insurance rates are adjusted to cover losses and expenses as the law of averages fluctuates.

Losses recoverable. A bond resembles a "loan"; the surety is "lending" its credit to the principal. After a claim is paid, the surety expects to recoup its losses from the principal. Unfortunately, actual experience shows few such recoveries.

Losses usually not recoverable. When an insurance company pays a claim, it usually doesn't expect to be repaid by the insured.

Premiums cover expenses. A large portion of the surety bond premium is really a service charge for weeding out unqualified candidates and for issuing the bond.

Premiums cover losses and expenses. Insurance premiums are collected to pay for expected losses. If an insurance company can get enough average risks of one class, it will always have enough money to pay losses and the expenses of doing business.

Sureties are selective. A surety agent is selective. Like a banker, he is trained not to make any bad loans.

Insurers write most risks. The insurance agent generally tries to write a policy on anything that comes along (at the appropriate premium rate) and allows for a large volume to cover the risk.

When the surety company is called in, the principal has usually paid as much of the loss as he is able. At this point, the surety company must pay the difference. The surety then tries to reclaim its loss from any resources left to the principal. In some cases the surety recoups all of the money it had to pay the obligee. In most cases, however, the principal either cannot be located or proves to be insolvent.

In reality, no obligee wants a claim against a surety bonding company. The obligee wants the principal to carry out his obligation. A surety bond is written because the obligee expects the surety company to weed out any applicant who cannot fulfill his commitments.

Are there alternatives to Surety?

The job of the surety bonding company has become as complex as the rest of our economic society. In an age of lawsuits, broken promises, bankruptcies, and a generally high level of financial instability, the surety company provides basic public protection. To do this, the surety must responsibly determine the qualifications of those who wish to be bonded.

A surety provides the best method for guaranteeing performance and protecting public interests. Still, people tend to distrust business—even when history proves that private enterprise has been the consumer's single most important benefactor.

The government has tried many programs to provide surety guarantees for the public. None of them have worked well.

"Risk pooling" and so-called "state funds" have been tried in all their various forms. Risk pooling is

a government program which "assigns" to surety companies various applicants who are unable to obtain bonds elsewhere. State funds are nothing more than state agencies which go into the bonding business. In almost every case, both concepts have failed.

There are three important reasons for this failure:

1. Insolvency--In many cases, state funds are too liberal in their payment of claims. The resulting problem is evident; the state fund becomes insolvent. During the 1980's there have been a few state funds which have gone bankrupt. When this happens, either the state or the licensees have to make up the difference, or the consumers must go without recovery.

2. Difficult Recovery--In other cases, the state has tried to reduce losses by making it so tough for a consumer to get a claim paid that it's not worth the effort. Most recovery funds require that the consumer obtain judgments and exhaust all civil and administrative remedies before they can submit a claim against the fund.

By comparison, bonding companies are bound by laws that require timely and proper claims handling procedures. The surety always pays promptly upon being shown a minimum amount of proof of loss.

3. Surety bonding does not depend upon the law of averages. Losses cannot be expected to be covered by "premiums". Only through proper and exacting underwriting procedures can surety bond-

ing be profitable, reliable and valuable for public and private protection.

In short, corporate sureties have the necessary knowledge, experience and expertise in the especially crucial areas of underwriting and claims handling. State funds are not only lacking in these areas; they also frequently lack the proper staffing.

Public protection can only be maintained by an independent party - the surety. In addition, by taking responsibility for investigation, evaluation, and recovery of loss, corporate sureties keeps thousands of cases out of the legal system every year. The result is additional public savings.

The seven families of Surety Bonds

1. Fidelity Bonds

There is always the possibility that an employee will steal. Statistics show a shocking increase in employee theft. They also identify theft as *the leading cause of small business failure*. The only protections against this kind of loss are good internal control, regular outside audits and a Fidelity Bond.

Fidelity Bonds are often referred to as "honesty insurance." They cover loss due to any dishonest act of a bonded employee. The employee may steal alone or with others. The loss may be money, merchandise or any other property, real or personal.

The Fidelity Bond is available in a group (blanket) or individual (schedule) form.

2. Public Official Bonds

Public Official Bonds guarantee taxpayers that the official will do what the law requires.

A public official is expected to "faithfully perform" the duties of the office. For this reason, bonding public officials is highly important. It isn't enough to simply buy honesty insurance. "Faithful performance" is not synonymous with "honesty." It may include honesty along with many other important factors.

For instance, a county treasurer may have lost funds through a failure of a bank he thought was sound. If the treasurer did not obtain proper depository security, he could be held liable for restitution. The county treasurer could easily prove that he did not act "dishonestly." However, he would have difficulty proving that he "faithfully performed" his duty.

Public Employee Bonds are also available for bonding the subordinates of the public official (those people who are not required by statute to be bonded). Those subordinates need to be bonded for dishonesty only.

Public Official Bonds may be written for individuals or, where the law allows, on a blanket bond form.

3. Judicial Bonds

Judicial bonds are written for parties to lawsuits or other court actions (plaintiffs and defendants).

In anticipation of a favorable judgment, plaintiffs often want to take possession of the property, cash or merchandise in question without waiting for the trial. Those who are financially reliable can often

achieve that goal by posting a plaintiff's court bond.

The plaintiff's bond is usually required to protect the defendant should the court decide that he, and not the plaintiff, is entitled to the property or the judgment.

Types of plaintiff bonds include Indemnity to Sheriff Bonds which protect the sheriff against suit when dispossessing a person of property or goods and Cost Bonds which guarantee payment of trial costs.

Other types of plaintiff's bonds include Cost on Appeal, Injunction, Attachment, Objecting Creditors, Replevin and Petitioning-Creditors-in-Bankruptcy Bonds.

The second type of Judicial Bond is the defendant's bond. A defendant in a court case might want a bond to counteract the effect of the bond that the plaintiff has furnished.

Some common types of defendant's bonds are Release of Attachment and Counter Replevin. Generally speaking, these bonds have proven to be more hazardous than plaintiff's bonds. Accordingly they can only rarely be written without the posting of adequate collateral to protect the surety from loss.

In criminal actions, bail bonds are the most common type of defendant's bonds. They guarantee that the defendant will show up for trial.

4. Fiduciary Bonds

A fiduciary is a person appointed by the court to handle the affairs of persons who are not able to do so themselves. The fiduciary is often called a Guardian or Conservator if he handles the affairs of a minor or an incapacitated person. An Administrator is a fiduciary who handles the affairs of some-

one who has died; he or she is known as an Executor if specifically named in the will.

Fiduciaries are often required by statute, courts, or wills to be bonded. Statutes prescribe how fiduciaries should handle others' affairs. However, the surety company often assists in keeping the fiduciary within the law.

Assistance of a surety is available to the principals or their attorneys. Supervision by the surety helps prevent problems and secure the assets entrusted to the fiduciary. Through careful underwriting practices, a surety also attempts to minimize losses.

In addition to the loss prevention services performed by a surety, the bond creates protection. *If there should be a loss, the surety pays heirs, wards, creditors, and beneficiaries.*

5. License and Permit Bonds

A business takes few actions today without governmental permit or approval. Many of these government permits are granted only after the business posts a bond guaranteeing compliance with laws, ordinances, and regulations.

License and Permit Bonds "put teeth" into the laws passed for public protection. For example, sewer builders must conform to city sanitary regulations. They must give a bond to guarantee compliance with city regulations. If they do not comply, the surety pays damages or ensures compliance. The surety's great care in selecting its risk helps insure that only capable sewer builders will be licensed. License and Permit Bonds are divided into five classes:

- (A) Those designed to protect the health and

safety of the public, e.g., a sewer builder.

- (B) Bonds required of an individual who has been granted some public privileges which may become a hazard to the general public, e.g., hanging a sign over the street.
- (C) Those bonds which protect the public against loss of money or goods entrusted to the licensee, e.g., real estate broker, public warehouseman, etc.
- (D) Those required of businesses highly susceptible to unscrupulous practices, e.g., small loan companies, motor vehicle dealers.
- (E) Bonds which guarantee payment of taxes collected, e.g., gasoline tax bonds, sales tax bonds.

This latter category represents one of the most important types of surety bonds. These bonds guarantee that the principal will pay over to the state all tax monies received. In the event the principal fails or is unable to pay the tax, the surety company pays for any losses. Without corporate surety, a state program may not be able to collect its revenues.

In all these cases, bonds endeavor to protect the public against irresponsible licensees.

6. Contract Bonds **(Bid and Performance Bonds)** **Bid Bonds**

Bid Bonds are usually the first step in a bonded contract process. Each bidder for a contract must guarantee the price bid by posting a certified check

or indemnity bond, which is forfeited if the contractor fails to enter into the contract awarded. Usually the amount forfeited is the difference between his bid and the next lowest bid. The charges for Bid Bonds are nominal so as to encourage contractors to use Bid Bonds rather than certified checks.

Bid Bonds guarantee that the contractor will enter into a contract at the amount bid. When he does this, the Bid Bond is released.

Performance Bonds

The Performance Contract Bond guarantees performance of the terms of a contract. It may be for the construction of a building or road or it may be a supply contract. It may be a transportation contract or almost any kind of contract where one party might experience harm if the other party fails to perform.

The Performance Bond is largely the result of governmental and other public bodies which are required by law to award contracts for public work to the lowest responsible bidder. The requirement of a Performance Bond and the screening process which the surety must do, eliminates unqualified contractors before the bidding process begins.

Performance Bonds are also frequently required in the private sector, including residential construction. In most cases, the bond guarantees completion of the work and payment of all labor and material costs.

7. Miscellaneous and Federal Bonds

There are almost as many categories of surety bonding as there are categories of agreements, con-

tracts and situations where people may fail to perform as promised.

Some of these are:

- (A) Bill of Lading Bonds, Adoption Bonds, Financial Responsibility Bonds and Travel Agency Bonds.
- (B) Lost Securities Bonds.
- (C) United States Excise Bonds. (Includes Brewer's Bonds, Distiller's Bonds, Industrial Alcohol Bonds, Wine Maker's Bonds, and Tobacco Manufacturer's Bonds.)
- (D) Custom Bonds. (Includes Importer/Exporter Bonds, Carrier Bonds, and Warehouse Bonds.)

There are many others too numerous to mention. In these special situations, the experience of a corporate surety can be very helpful.

The Surety Bonding Agent

The surety bonding business is hazardous--and always has been. Francis Bacon once said that "Going surety for a neighbor is like putting on iron to swim." Still, the need for bonding grows daily. Therefore, the number of agents required to service this great need also increases.

Agents are the link between the surety company and those who need bonds. The primary source for bonding agents is established independent insurance agents. And today, most licensed independent casualty agents write at least some surety bonds. **Only licensed insurance agents can sell surety bonds.**

Licensing individual agents helps keep unscrupulous and incompetent people from doing

business on behalf of a surety. Agents must also sign a contract with the company they represent. The contract and the license are necessary because each agent is granted certain authority agreed upon by the company and agent.

Agents are often granted a Power of Attorney which gives them the authority to execute bonds. Each agent is limited in the amount and type of bonds that can be executed.

Powers of Attorney and pre-executed bond forms literally put a surety company in the agent's office. The agent can execute a bond on the spot. This requires the use of considerable discretion and is an important part of this highly service-oriented industry.

How is a Surety Bond Sold?

The typical sales problem of creating a need is not a factor in the surety business. A need for the bond has already been created either by law or by the nature of a particular business.

The surety agent earns a commission providing the customer's bond. Until that bond is properly executed and filed, it does not begin to function. Therefore, availability is critical.

Since an agent cannot "create a need" for most surety bonds, service and availability are key to becoming the source when bonding needs arise.