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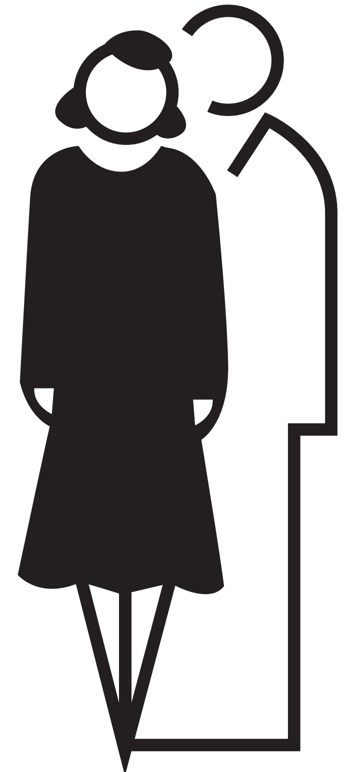
### Standing behind the obligation

# Surety bonds as negotiation tools



Surety bonds have more uses than you probably imagine. Here's a primer on how to effectively employ them to protect your client.

**By Thomas Whittemore**

It can be challenging when a litigator, corporate, intellectual property or other commercial attorney is preparing to enforce a court order only to see or hear the words "surety bond" arise as a precondition for his or her client's remedy. Trusts and estates attorneys and elder law attorneys may hear those same words raised as a precondition to appointing their clients as a fiduciary. What does one do? What are surety bonds, and why are they necessary?

The best and most concise description of surety bonds presented to me came from a senior underwriter/manager for one of the large surety companies. Simply put, he stated that bonds are tools for negotiation. Thinking it over a few times, I could not argue with his assessment. Literally, they represent a guarantee from one party, the "principal," to another party, the "obligee" that is guaranteed by an insurance company's, "surety's," assets. The surety protects its position by securing an indemnification from the principal (bond applicant).

Although surety is regulated by state insurance departments, the surety obligation is almost diametrically opposed to insurance guarantees. Risk must be present to have an insurable interest; however, surety bonds are underwritten to avoid risk completely, or at least mitigate it, with the surety accepting collateral to solidify its position. Also, insurance is a two-party obligation (insurer-insured), whereas, surety is a three party obligation (surety-principal-obligee).

Surety is actually a credit business based on its underwriting and enforcement, and one may wonder why it is not regulated as a banking/commercial lending industry. There are times when surety bonds actually compete against financial institutions' letters of credit, not only in use, but also in pricing. Surety is priced by individual bond classifications for which actuarial tables have been prepared. The rates are submitted to and ultimately approved by state insurance departments. Although rates are assigned to specific classes of bonds, sureties may provide flexibility in their pricing by filing deviations that may be applied to the rates when certain conditions exist or are met. Some sureties file rates created by a surety association, an advocacy group that, among other things, analyzes the actuarial data available to mete effective rating schedules.

## Classifications

The two main classifications of surety bonds are contract surety and commercial surety, and I have been engaged primarily as an underwriter of commercial surety for the past 21 years. Commercial surety has a wide berth; within the classification is another area known as court bond surety. Historically, the court bond and other parts of the commercial surety business have performed very consistently. That makes sense when considering surety underwriters' goals of avoiding risk. It also means the underwriting has been mostly effective.

Court bonds are broken into two main sub groups: Fiduciary bonds and litigation bonds. The court bond world in the metropolitan area is a rather small community consisting of a few well known agents who specialize in

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that niche. Some insurance agents engage in surety, but mostly through their commercial clients. The main client base for the court bond agencies are lawyers since they represent the estates, guardians, and litigation for which many court bonds are written.

Surety bonds have real value to attorneys and their clients, and the attorneys who need them for their practice have some understanding of their use and need. But my overriding impression has been that many attorneys have a limited understanding of the value of surety bonds and an understanding of the mechanisms involved.

**Fiduciary bonds provide inexpensive insurance for the estate of a decedent or incapacitated person and the estate creditors.**

Fiduciary bonds provide inexpensive insurance for the estate of a decedent or incapacitated person and the estate creditors. They guarantee the performance of the fiduciaries appointed by the Surrogate's and Superior courts. Thus, they provide a remedy in the event an administrator, executor, guardian of minor or guardian of an incapacitated person misuse or negligently mishandle monies of the estates they represent. They also guarantee all creditors will be sought and their claims resolved. The bonds remain in effect until the guarantee has been completely met; once accomplished, the bond obligation may be extinguished. This is accomplished either by court order discharging the bond and releasing the surety from its obligation or more informally when the sureties allow.

Surety bond language is not lengthy and the actual bond guarantee normally does not exceed one or two paragraphs. In most cases the bond recites language directly from legal statutes addressing the fiduciary responsibilities of the principal. At some level the courts interpret the surety's liability in the event of a claim, but it is limited to a reasonable interpretation of the fiduciary's responsibility that may adhere to the surety.

## Some situations

Is a fiduciary liable for investing a minor's monies in a blue chip stock that subsequently diminishes greatly in value based upon circumstances unknown at the time of the investment? Probably not. In such a scenario it would not be reasonable to expect the fiduciary to anticipate a drop in value; the investment was reasonable at the time the decision was made.

Is a guardian of an incapacitated person liable for monies spent constructing a swimming pool that the incapacitated person could not be expected to use in his or her lifetime? That individual's decision could very well fall within the parameters of a claim as guaranteed by a guardian bond. These are the types of issues sureties grapple with when evaluating fiduciary bond claims. Ultimately, such an event will come full circle and future underwriters may seek ways to underwrite guardian bonds to avoid being harmed by such an error in judgment that could result in a financial loss. On the other hand it is critical that estates have protection against fiduciaries who misuse and mishandle estate assets.

Attorneys may play an effective role in helping minimize surety losses, ultimately making it easier to write bonds for qualified applicants. For example, by maintaining contact with their fiduciary clients, trusts and estates attorneys and elder law attorneys may recognize fiduciaries' errors that could adversely affect the estate they represent. It is not possible to micromanage the clients, but by periodically reviewing the fiduciaries' accounts, the attorney may recognize problems early on in the process and avoid catastrophic or significant losses to estate assets. The largest claim I have been privy to was a guardianship where the fiduciary extracted monies from the accounts over a three-year period. It was evident when looking at the withdrawals that initially, small amounts were removed, and only on occasion. Over time the amounts and frequency of the withdrawals increased and amounted to a large loss difficult to recoup. Reasonably close oversight could have mitigated the loss that was to follow.

## Litigation bonds

Earlier I described surety bonds as tools for negotiation. Although that analysis may be applied to both fiduciary and litigation bonds, it is more commonly seen on the litigation end of the business. The most frequently needed litigation bonds are appeal/supersedeas bonds; attachment; discharge of attachments; bonds to discharge mechanic's liens; discharge *lis pendens*; preliminary injunction; replevin/seizure; security for costs; TRO bonds; and bonds to vacate default judgments. The posting of these bonds in court, as required either by statute or court order, initiates the actual litigation or may lead to negotiation of the dispute between the parties to the litigation.

An example: A judgment debtor chooses to appeal an adverse money judgment entered against it. By filing a supersedeas bond in the trial court along with a Notice of Appeal, the judgment debtor may stay execution of the judgment obtained by the judgment creditor. If the judgment debtor does not appeal the judgment, the judgment creditor will either satisfy the debt or the creditor will file restraining notices against the judgment debtor's accounts to access the monies awarded it.

However, there are various reasons that a judgment debtor files a supersedeas bond. First, the judgment debtor may believe the trial court erred factually or legally in determining and entering the judgment, and believes the appellate court will reverse the judgment. Alternatively, the judgment debtor may appeal the judgment with hope the appellate court may reverse the trial court; but at the same time, the appeal will provide time to negotiate a settlement in a smaller sum than the judgment. The filing of the bond provides the judgment debtor with an opportunity to settle the dispute more favorably and extends the time the debtor has to satisfy the judgment if it is affirmed by the appellate court.

Conversely, the bond protects the judgment creditor in the event the appellant is unsuccessful in reversing the judgment. It covers the judgment plus post judgment interest that accrues

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during the appeal. So although the judgment creditor is restrained from executing against the judgment, it is nonetheless protected by both the judgment debtor's and the surety's assets in the event it ultimately prevails. Ultimately, it may also facilitate the judgment creditor's efforts to secure the court award from the judgment debtor since the surety is bound unto the obligation with its assets at risk.

It may appear comforting to have a surety bond in place in an amount designated by judge or statute to cover a specific obligation, but how is it enforced? This is another element of surety bonds that does not appear to be widely understood in legal circles. The surety bond, for litigation or fiduciary purposes, is a contract between the principal, obligee and surety. The surety binds itself to the obligee by guaranteeing the principal's obligation to the obligee. But remember: The surety secures an indemnity agreement from the principal, enabling it to indemnify itself by subrogating against the principal in the event it is forced to pay under the bond. Claims against bonds are normally made by the obligee when it does not receive the benefit of the obligation made by the principal.

Surety companies have claims departments overseeing claim activity against the bonds. The obligee's attorney will contact the surety through the agent who issued the bond or by reaching directly to the surety's claims department. The obligee states its case to the claims personnel and they, in turn, evaluate the claim. If the claims people determine the claim should be satisfied and met by the principal, they will contact the principal to satisfy its obligation.

If the principal satisfies the bond guarantee to the obligee, the bond will be canceled and the matter resolved. The surety will require a release of the bond, by court order or "so ordered" stipulation to be filed in court cancelling the bond and discharging the surety's obligation thereunder. A file stamped copy must be given to the bond agent.

However, the principal may not be satisfied with the court's decision, and it may utilize its right to appeal the decision or judgment to reverse its fortunes. The surety will not force the issue until the principal either decides to voluntarily end its appeal and satisfy its obligation or the principal's options expire or end, with the principal then forced to satisfy the obligation. In any event if the principal defaults completely or in part in meeting its obligation to the obligee, the surety will pay the difference. However, the surety then has the right to subrogate against the principal to become indemnified.

It may be argued the need for surety bonds is greater now than ever, and that bond requirements should be expanded. I advocate that position — and not simply in my role as an industry agent. As stated previously, bonds provide inexpensive insurance for estates in the event that fiduciaries abdicate their responsibilities. Litigation bonds provide an opportunity to negotiate solutions while protecting the interests of the parties adversely affected by the relief secured. If looked at from those perspectives, the value of surety bonds may become more apparent. Attorneys and judges might serve their constituencies even more effectively in taking a closer look at the value of bonds and utilizing their value in protecting estate assets and the estate creditors.

## Use in estate work

Often executors and trustees are not bonded, but why? Does the fact an individual is named to a position of trust in a will mean he or she is more trustworthy and capable to act in such capacity, especially where an estate may be complicated and contain vast and varied assets? It is certainly debatable. Guardians are often in place for extended periods of time and may be more vulnerable to being tempted, especially if they experience personally lean times. It is advisable for elder law attorneys to maintain vigilance over the estates their clients are handling to protect the estates from experiencing loss. The courts can help by reviewing their oversight procedures and making certain that they are effective and realistic.

Also, it is understandable the elder law profession advocates involving close family in acting as a guardian, but those individuals may not possess the acumen to handle estate assets as well as attorneys, accountants or other financial and/or business professionals, and should not necessarily be appointed as guardians of the property. Sureties will often decline to write bonds for unqualified individuals because historically, their actions are more likely to lead to claims.

As a defendant's attorney in a litigation matter such as a preliminary injunction, TRO and attachment proceedings, it is arguably beneficial to advocate for the plaintiff to provide a bond, especially if a judge chooses not to impose the requirement. Said bonds protect the defendant from being damaged in the event the relief provided was improperly granted. Injunctions are not granted unless certain conditions are met, including a strong likelihood of success on the merits. But even if a judge determines the criteria have initially been met, the perspective could change as the litigation unfolds. Filing a bond in court guarantees the defendant's interest is protected by the surety's assets.

Surety bond is not necessarily a daily part of the legal vernacular. But, surety bonds do have a role in legal litigation and fiduciary matters. Many attorneys become aware of surety bonds for the first time as they work through litigation or placing a fiduciary in charge of an estate's responsibilities. At that moment it is helpful to have at least a basic knowledge of what a surety bond guarantees and what its value is given the circumstances.

Rather than trying to waive its requirement or trying to make it disappear, lawyers can effectively use the surety bond beneficially and to their client's advantage. ⊙

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