THE CREATION OF THE RELATIONSHIP

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Introduction

Performance bonds are a specific type of contract and, thus, the starting point for understanding the unique position of the surety and its obligations and rights under such contracts and the common law is, quite obviously, the creation of the suretyship relationship. Within this general topic is, among other things, a basic understanding of the history of suretyship, the underwriting process, and the various types of bonds and bond forms. This chapter will also focus on the interplay between underwriting and the surety’s claim department, and the execution, delivery and acceptance of surety bonds and, relatedly, defects that may prevent or void the creation of the suretyship relationship.

1. History and Purposes of Surety Bonds

Principles of suretyship are widely traveled and have existed since before antiquity. “It is contended by some authorities that the general principles and relationships involving suretyship can be dated back to the earliest history of man in a societal relationship.”¹ The ancient civilization of Mesopotamia, for example, is known for being one of the first notable hubs of learning, writing, and religion. A lesser known fact about

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¹ Tex. W. Oil & Gas Corp. v. Fitzgerald, 726 P.2d 1056, 1066 (Wyo. 1986).
Mesopotamia is that it was home to the first known record of contract suretyship, dating back to 2750 BCE. The Library of Sargon I, King of Accad and Sumer, contains a tablet that records the making of a surety contract, which encompassed surprisingly modern features. The tablet describes a farmer (the obligee), who resided in the suburbs of Accad, and had been drafted to the King’s military service. He entered into a contract with another farmer (the principal) by which the latter agreed to cultivate the soldier/obligee’s farm for the period of the obligee’s absence. The principal also agreed to fertilize the land properly and to maintain the property and return it to the obligee upon the expiration of the lease in as good of condition as it was received by the principal. The principal, in return, was to receive one half of the farm’s produce. The obligee, of course, was in no position to personally supervise the performance of the contract by the principal because he was off serving King Sargon. Thus, so that the obligee would be properly secured, the tablet states that a merchant of the city of Accad, as a surety for the principal, guaranteed the performance of the contract by him.

Hammurabi ruled the Babylonians from 1792-1750 BCE. During his reign, he famously wrote one of the world’s first codes of law, aptly named the Code of Hammurabi, which included principles of suretyship that survive to this day. Robert Francis Harper has translated the code, in part, as follows: “If a man have bargained for the field, garden or house of an officer, constable or tax gatherer and given sureties, the officer, constable or tax gatherer shall return his field, garden or house and he shall take himself the sureties given.”

Suretyship became an important part of ancient trade. For example, in 509 BCE, Rome and Carthage used surety bonds to guarantee goods bought and sold between these empires. As recorded, a treaty between Rome and Carthage read: “Men coming to trade may conclude no business except in the presence of a herald or town clerk, and the price of whatever is sold in the presence of such shall be secured to the vendor by the state, if the sale take place in Libya or Sardinia.”

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3. Id.
5. Id.
Roman surety laws from circa 150 AD described different types of sureties depending upon the obligation undertaken: the sponsor, the fidepromissor and the fidejussor. Sponsores and fidepromissores could act as sureties only on verbal contracts, while fidejussores could be a surety on any undertaking “whether re verbis, litteris, or consensu.” Sponsores were also required to be Roman citizens. Unlike the current business model of the compensated surety, the Romans believed suretyship was rooted in duty, not compensation.

The Anglo-Saxons in England also engaged in suretyship and they, like the Romans, held the notion that suretyship was rooted in duty. However, they uniquely used suretyship as a form of criminal law enforcement, whereby individuals—a family member, a master for servants, a lord for dependents—became responsible for producing others in court in the event of misdemeanors. Suretyship is even mentioned in the bible, most notably being referenced throughout the Book of Proverbs.

In the late nineteenth century, performance bonds arose in the American construction industry in an effort to protect public treasuries against the significant risk of default on uncompleted public projects. Specifically, in 1894, the requirement that federal contractors provide performance and payment bonds was codified in the Heard Act. The Heard Act required that the performance and payment obligations of federal contractors be guaranteed by a surety bond issued by “good and sufficient” sureties, which included compensated corporate sureties approved by the Department of the Treasury. Corporate, compensated

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7. Id. at 158. (internal citation omitted).
8. Id.
9. See, e.g., Tex. W. Oil & Gas Corp., 726 P.2d at 1066 n. 1 (wherein the Wyoming Supreme Court noted: “A well-considered history ascribing the differing derivation of surety from Roman language and usage and guaranty from Teutonic history is to be found in Radin, Guaranty and Suretyship, 17 CAL.L.REV. 605 (1928-29).”).
11. See also L. Simpson, Simpson on Suretyship, 2 (1950) (“A thousand years before the birth of Christ, Solomon said: [‘]He that is surety for a stranger shall smart for it: and he that hateth suretyship is sure[‘].”) (internal citation omitted).
14. On August 13, 1894, the same day that it enacted the Heard Act, Congress passed an act authorizing the government to accept the bonds of approved
sureties flourished as a result of these enactments.\textsuperscript{15} Following the example of the Federal Government, numerous states adopted “Little-Heard Acts.”\textsuperscript{16} In 1935, Congress replaced the Heard Act with the Miller Act.\textsuperscript{17} States again followed the lead of the Federal Government in adopting “Little Miller Acts.”\textsuperscript{18}

\section*{II. What Is a Bond?}

Suretyship has been defined as a “contractual relation resulting from an agreement whereby one person, the surety, engages to be answerable for the debt, default, or miscarriage of another, the principal.”\textsuperscript{19} Thus, a performance bond is a contract and is to be construed according to the same rules that govern the interpretation of contracts in general.\textsuperscript{20} In fact, because contract and suretyship are so intermingled, the Restatement (Third) of Suretyship and Guaranty borrows heavily from the Restatement (Second) of Contracts.\textsuperscript{21}

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corporate sureties. U.S. Fid. & Guar. Co. v. United States, 204 U.S. 349 (1907). This led to the creation of what is known as the “Treasury List” of sureties approved by the U.S. Department of the Treasury as acceptable to write bonds for federal projects and the level of authority for each listed surety. See 31 U.S.C.A. §§ 9304, 9305.


\textsuperscript{16} See, e.g., Lake Cty. Grading Co., LLC v. Vill. of Antioch, 19 N.E.3d 615 (Ill. 2014) (construing the Illinois “Little-Heard” to require a public works “bond” that provided both performance and payment protection, and reading into a subdivision performance bond as a matter of law an obligation to pay claims as well as complete the subdivision work).

\textsuperscript{17} 40 U.S.C. § 3131


\textsuperscript{20} Mgm Grand Hotel, Inc. v. Cont'l Ins. Co., 129 F.3d 126 (9th Cir. 1997) (citing Restatement (Third) of Suretyship and Guaranty: Interpretation of the Secondary Obligation § 14 (1995)).

\textsuperscript{21} The Reporter’s Notes to the Restatement (Third) of Suretyship and Guaranty (1995) sections acknowledge indebtedness to the Restatement (Second) of Contracts, especially in the provisions concerning formation of the suretyship contract.
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In the past, sureties were deemed “favorites of the law” and were afforded a strictissimi juris construction of their obligations. This was because, historically, sureties were individuals. Their status as compensated surety, however, is being increasingly and unfortunately relied upon by courts to abrogate the principle of strictissimi juris to the detriment of the surety.22 Courts are, and have been for some time, moving away from this body of law based upon the rationale that surety companies, including insurance companies that issue surety products, are being paid premiums for the issuance of bonds. However, the surety professional should endeavor to educate courts, which may not be attuned to all of the principles of suretyship and the surety-related relationships, on the distinction between insurance and suretyship and that the policies that supported strictissimi juris in the past should continue to apply. This proves important because oftentimes the corporate principal’s individual owners, and his or her spouse, bear the ultimate responsibility under the bond pursuant to their indemnity obligation to the surety.23

A. Defining Features of a Surety Bond

A surety bond is, generally, a three-party agreement between the surety, its principal, and the obligee. While the bonded contract is often incorporated into the bond by reference, and the surety agrees to be bound with the principal to the obligee with respect to the bonded obligation, the bond may, like any other agreement, limit the surety’s obligation by the terms of the bond itself. Indeed, as discussed in more detail below, surety bonds may include conditions precedent to the triggering of the surety’s

22. In the January 2018 Surety Claims Institute Newsletter, Armen Shahinian makes a compelling argument for compensated sureties, even insurance companies that issue surety products among their other lines of business, to remain favorites of the law. Armen Shahinian, Strictissimi Juris and the Compensated Surety, 32 Surety Claims Institute Newsletter 2-4 (2018). For this position, Mr. Shahinian relies, in part, upon the nearly universal economic arrangement associated with suretyship whereby individual indemnitors execute an indemnity agreement in which they assume personal responsibility for any loss the surety may incur. Thus, because the individual indemnitors are themselves acting as sureties (to the surety that wrote the bond), “the old relationship of a non-compensated surety is effectively preserved, and the ultimate loss will rest with such individuals if the loss to the surety is not otherwise avoided.” Id. at 3.

obligation. And, the bond typically includes a recitation of the surety’s maximum liability, which is what practitioners refer to as the penal sum limitation.

**B. Suretyship v. Insurance**

To the initiated, suretyship is clearly not insurance. Insurers issue policies accepting the risk that a fortuitous event will occur and are primarily liable for the damages arising from the insurable risk, up to the policy limits. Insurance policies are priced according to an actuarial analysis that the particular insured risk will occur. On the other hand, and as is discussed in more detail below, suretyship is a credit transaction, whereby the principal remains primarily liable for the bonded contract, and the surety underwrites the risk based upon the character, cash and capacity of the bonded principal.24

While there is some authority that expressly and correctly states that suretyship is not insurance,25 some courts and statutes continue to struggle with this obvious distinction. Most courts, however, are able to recognize that surety contracts and insurance contracts are conceptually and legally distinct.26 Courts have found that an insurer undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event, whereas a surety promises to answer for the debt, default, or miscarriage of another. In comparing surety bonds and insurance contracts, courts have also noted the differences between “their respective premium calculations, payments, and terms and conditions of cancellation and renewal” in support of “the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance.”27

Further distinguishing sureties from standard insurers is the tripartite nature of the relationship,28 where it is a third party (the obligee), not the

24. Id.
28. See Balboa Ins. Co. v. United States, 775 F.2d 1158, 1160 (Fed. Cir. 1985) (explaining suretyship status is created through a tripartite
principal, who is protected. This distinction is important because it gives rise to the surety’s equitable rights of subrogation. “The theory of equitable subrogation is based on the view that the triggering of a surety’s bond obligation gives rise to an implied assignment of rights by operation of law whereby the surety ‘is subrogated to the [principal contractor's] property rights in the contract balance.’” Thus, for example, when a general contractor’s surety performs the underlying obligation by completing work or paying subcontractors, the surety fulfills not only its contractual obligation under the bond but also the general contractor's contractual duties to the obligee and to subcontractors. In doing so, pursuant to the doctrine of equitable subrogation, the surety steps into the principal’s shoes, among others, and acquires the principal’s rights. The right of the subrogated surety to be paid from funds held by the obligee arises in equity. Sureties bond projects with this right in mind and with the legitimate expectation that the security ensuring performance of the underlying obligation will be properly applied. And, the improper release of the bonded contract funds gives rise to the surety’s overpayment defense, which could serve to discharge the surety.

The fundamental distinctions between suretyship and insurance are particularly important when analyzing the scope of the surety’s obligation and the applicable rules of interpretation. Much of the confusion stems from the fact that compensated sureties are almost invariably insurance companies that write surety bonds in addition to their insurance products and have “Insurance Company” in their corporate agreement “whereby one party (the surety) becomes liable for the principal's or obligor's debt or duty to the third party obligee”).

30. See, e.g., Merchants Bonding Co. v. Pima Cty., 860 P.2d 510 (Ariz. App. 1993) (holding that the surety was entitled to recover as damages the amount of final payment where the obligee had released final payment to the principal without the surety’s consent and over the surety’s protest).
31. See Auto Owners Ins. Co. v. Travelers Cas. & Sur. Co., 227 F. Supp. 2d 1248, 1261 (M.D. Fla. 2002) (“Defective construction is an occurrence under a CGL policy . . . However, CGL policies ‘only protect against personal injury or damages to personal property which might result from the defective workmanship. The policy does not afford coverage for the repair of the defective workmanship itself.’ . . . ‘[T]he poorly performed work will perforce have to be replaced or repaired by the tradesman or surety’”) (quoting Weedo v. Stone–E–Brick, Inc., 405 A.2d 788 (N.J. 1979)).
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Moreover, in most states, surety companies are regulated by the state insurance commissioner or similar state official. Thus, at the creation of the suretyship relationship, the surety would be wise to explain to its principal that it is not an insurer, but rather is contemplating issuing surety credit on behalf of the principal for which no loss is expected, and that should such loss arise, the surety will look to the principal and indemnitors to be made whole. 32

III. Underwriting Considerations

Underwriting the issuance of surety credit need not be mysterious to claim professionals. While the whole underwriting process is complex and beyond the scope of this chapter, the simple goal of underwriting is determining whether a particular risk, whether it be the issuance of a single bond or the expansion of an existing bond program, is eligible to be written. The practice of surety underwriting is often simplified to being an analysis of the proverbial three C’s: the capital (or financial position), character and capacity of the principal. Thus, in determining whether to take on a particular risk, an underwriter may require the following documents and information: a) year-end corporate financial statements; b) aged schedules of accounts receivable and accounts payable that tie to the financial statements and demonstrate trends; c) work in progress and completed job schedules; d) affiliates (if any); e) personal financial statements of the individual owner of the principal; and f) any credit and banking information. The examination of these criteria includes, but is not

32. Although suretyship is not “insurance”, a number of insurance companies in recent years have begun to offer an insurance product known as “contractor default insurance,” that purports to afford protection generally against the same contract performance and payment risks traditionally protected by surety bonds. See Gray, Point/Counterpoint: Default Insurance—An Alternative to Traditional Surety Bonds, 22 Constr. L. 17 (2002). When purchased by the general contractor, the policy covers costs associated with defaults of all subcontractors working for the general contractor. Such a policy is typically referred to as “subcontractor default insurance.” When purchased by the project owner, the policy typically covers defaults by the general contractor and the subcontractors. Conventional surety bonds are prevalent in government projects, where laws that some would say are outdated appear to mandate purchase of this specific product. By contrast, default insurance has developed in the private market where innovation is possible in response to market forces and where traditional bonds are optional, not mandated.
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limited to: 1) thorough analysis of the principal’s financial history; 2) a review of references from those with whom the principal has worked in the past; 3) consideration of the reputation and personal integrity of the principal’s owners and senior leadership; and 4) the principal’s experience (successes and failures) in prior work.

Moreover, surety underwriters also measure a given principal against industry norms and the corporate underwriting guidelines of their respective organizations. Adhering to specified criteria enables the underwriter to assess creditworthiness against an established baseline. The objective is to accurately forecast the principal’s ability to successfully complete its contractual obligations, to mitigate risks, and to avoid and/or address potential claims without the surety’s involvement. Underwriters collaborate with 1) producers and surety agents, who assist in business generation and compiling underwriting materials; 2) accountants, who counsel on the financial well-being of the account or potential account; and 3) lawyers. Each such advisor plays a critical role in the understanding of the overall underwriting puzzle.

A capable underwriter will not put the surety company’s loss ratio and balance sheet at risk unless she is confident that the principal is a reputable firm that is generally capable of successfully completing the work, but also has the financial wherewithal, management capabilities, sophistication, insight and desire to work with a surety, and its claim team, during challenging times to mitigate the risk and/or damages.

Moreover, a differentiating trait of suretyship from insurance is that the surety invariably secures from the principal, the principal’s individual owners and perhaps other affiliated individuals, an agreement of indemnity,33 wherein such individuals agree to indemnify the surety for all losses, costs and expenses resulting from a bond’s issuance. Insurance policyholders, on the other hand, are not obligated to reimburse the insurer for paying a claim under the insurance policy. Also, insurance premiums are priced based on actuary models and predictions of claims or loss experience, and the risks are typically pooled among insurers and reinsurers. In surety, there are no loss-paying pools, and surety premiums are simply fees which cover underwriting expenses. When a surety bond

33. See Stewart R. Duke & Mary Jeanne Anderson, How Contract Surety Bonds Are Underwritten, in THE LAW OF SURETYSHIP 58, (Edward Graham Gallagher ed.) (1993) (“We feel that [providing personal indemnity to the surety] is a manifestation by the stockholders and/or partners of a construction firm, that they are fully behind their company and have faith enough in their company to, as we say, ‘get on the line’”).
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is written, the bond principal and the individual indemnitors are required under the indemnity agreement to ensure that the surety suffers no loss and incurs no unreimbursed expense by reason of a claim being made under the bond. This places the ultimate responsibility for any performance default with the party who is primarily responsible for that performance, i.e., the principal, together with the individuals that control the principal, rather than with the surety, who is only secondarily responsible for that performance.

Underwriters simultaneously wear many hats. They are business consultants, market analysts and relationship managers with agents. They are also trusted advisors with principals, as well as valuable resources for claim and/or legal representatives. With that in mind, revenue (or premium) production and growth is often the prime objective, and, along with loss ratio, is the typical performance measure for surety underwriters. Effective underwriters strike a balance between, on the one hand, business generation and marketing, and on the other, protecting the financial assets of their respective companies.

A common functionality of surety bonds is the principal’s fulfillment of a statutory requirement for public construction contracts. The statute pursuant to which the bond is being issued may dictate the particular form of the bond, but oftentimes such statutes do not dictate the form to be used. Additionally, private owners and/or developers may require general contractors to obtain performance bonds naming the owner as obligee, and general contractors may require their trade subcontractors to provide performance bonds naming the general contractor as obligee, and potentially the private owner as an additional obligee. In the private sector, the bond form is typically dictated by the party having the most leverage in drafting the contract documents, which is typically the owner over the general contractor and the general contractor over the subcontractor. Below is a brief overview of commonly used bond forms:

34. See, e.g., N.J. STAT. ANN. § 2A:44-147 stating: “The bond required by this article shall be in substantially the following form” and providing the complete bond form.

35. The performance bond obligation traditionally is expressed in conditional “defeasance” language regardless of the bond form, which simply declares that the bond obligation is “null and void” upon performance of the bonded contract in conformance with its terms and conditions. Defeasance language assures that the bond obligation becomes void upon performance without need for express cancellation of the bond and confirms that the bond obligation is not more than being coextensive with the contractor’s obligation under the bonded contract. See Quinn Constr., Inc. v. Skanska
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A. Statutory Bonds

Most public construction projects, including all federal construction projects with a contract value in excess of $100,000, require contractors to provide performance bonds and payment bonds.36 “Surety bonds are integral to the government contracting process, for through the surety system the government enters into arrangements with reduced risk, by drawing on the responsibility and resources of the surety.”37 Because the bonding requirements for public projects are typically established by statute, the statute typically also defines the surety’s obligations under its performance bond.38 However, even though statutes often set forth specific conditions for the surety’s performance and specify the required penal sum, many states that require statutory bonds do not have their own standard bond forms.

B. The American Institute of Architects Bond Forms

The American Institute of Architects (the “AIA”), among other things, creates standardized construction contracts, including commonly used bond forms. In 1970, the AIA created the AIA Document A311 Performance Bond, which requires a declaration of default by the obligee to trigger the surety’s obligation, and, upon fulfillment of the condition, permits the surety to select among “promptly remedy[ing] the default,” completing the bonded contract or tendering a replacement contractor and paying the difference between the remaining contract balance and the cost.
of the replacement contract. In 1984, the AIA released the AIA Document A312 Performance Bond, which sets forth a series of conditions precedent to the surety’s obligation, including, but not limited to, a pre-default meeting, a declaration of default and termination thereafter and dedication by the obligee of the contract balance towards completion of the remaining work. 39

C. Subcontractor Bonds

Sophisticated general contractors may require their trade subcontractors to obtain payment and performance bonds. The form of the subcontractor performance bond is usually dictated by, and annexed as an exhibit to, the subcontract. Surety underwriters and producers should be mindful that general contractors often require their subcontractors to obtain performance bonds with onerous surety obligations, including, but not limited to, potentially unlimited increases to the surety’s penal sum liability as the principal subcontractor is granted additive change orders. Additionally, an unfortunate trend in subcontract bonds is emerging wherein general contractors, which dictate the bond form, impose strict, and sometimes abbreviated, timeframes within which the surety is required to respond and/or make a performance election. We have seen bond forms wherein if the surety fails to make a performance election within a short time after the default, the surety is deemed to have waived its right to complete (and thereby mitigate its damages), and instead is obligated to indemnify the obligee for its costs, over which the surety would then have no control.

D. Defeasance Bonds

A defeasance bond form merely recites defeasance language and not much more. The defeasance bond includes simplistic language such as, if the “contractor shall promptly and faithfully perform [the] contract... then this obligation shall be void, otherwise it shall remain in full force and

39. Other organizations, such as the Engineers Joint Contract Documents Committee, also have created standardized performance bond forms. See EJCDC Doc. No. C-610 (2002); EJCDC Doc. No. 1910-28A (1984).
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effect. \(^{40}\) When the obligee makes a claim against a defeasance bond, the surety may be afforded its common law right to complete. \(^{41}\)

**E. Bid Bonds**

Almost all public bid invitations, and many private invitations, require each bidder to obtain a bid bond, or other bid security such as cash or a letter of credit, ensuring that the lowest responsible bidder will in fact enter into the contract. \(^{42}\) Bid bonds are usually required to be between 5 and 10 percent of the bid, and may be issued by surety companies to their principal clients as a courtesy and so as to secure for the surety the ultimate, and more lucrative, contract bonds.

A typical bid bond provides that, if the principal is awarded the contract but fails to enter into the contract and provide required payment and performance bonds, the obligee can make claim against the bid bond for its actual resultant damages—usually the additional cost of contracting with the next lowest bidder—up to the penal sum of the bond. However, some statutes, and some advertisements for bids, may mandate that the bid security constitutes liquidated damages. In that circumstance, so long as the obligee can meet the general requirements for establishing an enforceable liquidated damages provision, the entire penal sum may be forfeited without regard to any actual damages suffered by the obligee. \(^{43}\) The bid bond surety is ordinarily under no obligation to issue performance or payment bonds after furnishing the bid bond, \(^{44}\) despite the fact that the surety’s failure to provide that bonding may well lead to termination of the contractor for breach of contract if it cannot secure bonding from another surety. Ordinarily, that consequence does not

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41. The applicable state common law supplies the “tradition” along with surety industry practices. This conclusion is similar to the tradition in the construction world, when the party shouldering the obligation to achieve a certain outcome is also granted the right to choose the means and methods to reach that outcome. See, e.g., BRUNER & O’CONNER ON CONSTRUCTION LAW, § 12:80.
42. A completing surety that has the time to seek bids for a completion contract may consider it advisable to obtain bid bonds from its bidders.
44. Some state statutes require that the bid bond be accompanied by or serve as a consent of the surety to issue performance and payment bonds. See e.g., N.J. STAT. 40A:11-22 (2009).
provide grounds for recovery by the contractor from the surety for at least two reasons: 1) the standard general indemnity agreement between the contractor and surety specifically negates any duty or obligation by the surety to issue additional bonds; and 2) the standard bid bond makes clear that the obligation to furnish performance and payment bonds rests primarily with the contractor, and the surety’s secondary obligation and exposure to damages is limited to the penal sum of the bid bond. In addition, sureties and their producers should be mindful of the bond form requirements of the jurisdiction so as to avoid a circumstance where a principal’s otherwise responsible bid is rejected because the executed bond forms included with the bid did not comply with the statutory or contractual requirements. To that end, sureties should consider including in their indemnity agreements an acknowledgement by the principal that it is responsible for providing owners with the correct bond form and a waiver by their principal and indemnitors of any alleged damages relating to errors by the surety as to the execution and delivery of bonds.

IV. Execution, Delivery and Acceptance

The general requirements of contract formation, namely, execution, delivery and acceptance, apply to surety bonds and are therefore governed by general contract law. Case law further supports the proposition that the bond does not become effective against the surety until it is delivered to and accepted by the obligee. The general law governing these contract requirements is well-settled. Once accepted, a bond, like any other contract, cannot be rescinded absent the mutual consent of the parties. A

49. City of Del Rio, 94 F.2d at 704.
rescission of a contract may be in writing or oral\textsuperscript{50} or may be expressed by actions.\textsuperscript{51}

In the surety context, the obligee must accept the bond for the obligee’s rights therein to vest.\textsuperscript{52} In the same vein, a surety issuing a performance bond for a subcontractor was deemed not liable under the bond before delivery and acceptance by the general contractor, even though the latter had relied upon advice from the subcontractor’s counsel that valid bonds were issued.\textsuperscript{53}

\textbf{V. Fraud by the Principal}\textsuperscript{54}

Generally, fraud committed by the principal will not discharge the surety’s obligations to the obligee under the performance bond, so long as the obligee is not itself involved in the fraud\textsuperscript{55} and so long as the obligee does not become aware, before entering into its contract with the principal, that the principal has defrauded the surety.\textsuperscript{56} The rationale for holding the surety responsible to the obligee in the face of principal fraud in most instances is that the surety is ordinarily in the best position to detect the fraud of its own principal. However, fraud in which the obligee is complicit will discharge the surety, and the obligee must have clean hands regarding the principal’s fraud for the surety to remain liable to the obligee for the bonded obligation.\textsuperscript{57}

\begin{itemize}
\item \textsuperscript{50} Frommeyer v. L. & R. Constr. Co., 261 F.2d 879, 882 (3d Cir. 1958).
\item \textsuperscript{51} Church v. Bobbs-Merrill Co., 272 F.2d 212, 215 (7th Cir. 1959).
\item \textsuperscript{52} Rachman Bag Co., 46 F.3d at 238.
\item \textsuperscript{53} SS Silberblatt Inc. v. Seaboard Sur Co., 417 F.2d 1043 (8th Cir. 1969).
\item \textsuperscript{54} See Eagle Indem. Co. v. Gill, 108 F. Supp. 936 (E.D. Ill. 1952) (In an action by surety against principal for fraud which induced issuance of performance bond, evidence established that principal had been guilty of such fraud and deceit in supplying surety with incorrect information in financial statement given in application for performance bond).
\item \textsuperscript{56} Restatement (Third) of Suretyship and Guaranty, Section 12(2) (1996).
\item \textsuperscript{57} See, e.g., G. & S. Foods, Inc., 438 F. Supp. at 125.
\end{itemize}
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VI. Fraud by the Obligee

While an obligee may not be deemed to stand in a fiduciary relationship with the surety, at a minimum, the obligee owes the surety a duty of continuous good faith and fair dealing.\textsuperscript{58} Thus, as with all contracts, suretyship induced by the obligee’s fraud or deception may be deemed void.\textsuperscript{59} “Fraud” may include intentional misstatement, nondisclosure or known concealment.\textsuperscript{60} However, courts have held that the obligee has a duty to disclose the information\textsuperscript{61} and the information is not something that the surety should have independently known.\textsuperscript{62} In an extreme example, the obligee knew that the surety would not have bonded the full cost of the contract, so it secretly arranged for the principal to only submit a portion of the contract for bonding, without disclosing to the surety the true scope of the overall undertaking. In such case, the surety was deemed to have been discharged.\textsuperscript{63}

VII. Unauthorized Acts by Agent

Agents and producers assist in the critical function of revenue (or premium) generation. Those not knowledgeable of the surety industry may find surprising the level of discretion afforded agents pursuant to surety issued powers of attorney. Sureties may face an uphill battle in

\textsuperscript{58} Sumitomo Bank of Cal. V. Iwasaki, 447 P.2d 956, 959 (Cal. 1968).

\textsuperscript{59} Restatement (Third) of Suretyship and Guaranty, § 12(1) (1996) (“if the secondary obligor’s assent to the secondary obligation is induced by a fraudulent or material misrepresentation by the obligee upon which the secondary obligor is justified in relying, the secondary obligation is voidable by the secondary obligor.”); see also Marine Bank, Nat’l Ass’n v. Meat Counter, Inc., 826 F.2d 1577 (7th Cir. 1987); Falco v. Alpha Affiliates, Inc., Civ. A. No. 97-494 M MS, 2000 U.S. Dist. LEXIS 7480, at *14-15 (D. Del. Feb. 9, 2000) (surety contracts voidable due to material misrepresentations).

\textsuperscript{60} See Ground Improvement Techniques, Inc. v. Merchants Bonding Co., 63 F. Supp. 2d 1272, 1276 (D. Colo. 1999) (denying plaintiff’s motion for summary judgment on surety’s counterclaim for rescission because of issues of fact surrounding whether issuance of bond was induced by concealment of material information).


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seeking to void a bond issued by an agent for which they have received a premium. “The authority of persons who signed a bond for a surety company may not ordinarily be questioned by the company where, with knowledge of the bond, it received the premium owing to it without repudiating the authority of such persons.” Moreover, statutes in many states establish an irrebuttable presumption of the apparent authority of an agent to bind the surety company, where that agent has been generally employed to receive bond applications and/or deliver bonds, and that agent in fact delivers a bond apparently executed by the surety to a person who accepts that delivery in good faith. The apparent authority of the agent to execute a bond that binds a surety for the benefit of an innocent third party is a mixed question of fact and may be left to the fact-finder to decide.

VIII. Mistake

As previously indicated, general principles of contract law, including the concept of mistake, are applicable to surety bonds. The right to rescind an offer for unilateral mistake will be sustained where the other party, from the very nature of the offer, should have been put on notice that the offeror was acting under a mistaken notion; that is, where the mistake should have been “palpable to the offeree.” As it is put in 1 Williston, Contracts § 94, an “offeree will not be permitted to snap up an offer that is too good to be true; no agreement based on such an offer can be enforced by the acceptor.” Of course, this right to rescission cannot be granted if the other party had so changed his position based on the offer that he would be prejudiced by the rescission. “A court of equity is always reluctant to rescind, unless the parties can be put back in status

64. 74 A.M.JUR. 2d Suretyship § 254 (2008).
65. Id.
66. 74 A.M.JUR. 2d Suretyship § 175 (2018).
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quo.” As a secondary guarantor of its principal’s performance, the surety may generally assert any defenses it has in its own right, together with such defenses as may be available to its principal on the underlying contract. At the same time, courts are not predisposed to accept a surety’s claim of mistake or misunderstanding regarding the terms of the suretyship agreement. 

IX. Illegality

A surety can assert illegality as a defense to the underlying contract. Further, a surety can assert illegality as a defense to performance under the bond. However, a claim that the bond is illegal because it fails to conform to statutory requirements is unlikely to prevail. If the bond terms conflict with statutory requirements, however, the judicial response may be to find that the statutory provisions control, rather than finding illegality. Furthermore, the illegality of the underlying contract may be insufficient to discharge the surety if the obligee retains causes of action against the principal other than in contract.

Conclusion

Suretyship has survived the test of time. It is the surety professional’s obligation to educate courts on the traditional bases for affording the surety favored status under the law, and why such traditional principles should continue to adhere even as to the compensated surety. In this regard, the surety claim professional will benefit from gaining an understanding of the surety product, how the relationship is created, and the interrelationship between the parties to the bond, contract and indemnity agreement.

71. Heifetz Metal Crafts, Inc. v. Peter Kiewit Sons’ Co. 264 F.2d 435, 440 (8th Cir. 1959) (quoting Grymes v. Sanders, 93 U.S. 55, 62 (1876)).
74. Id. § 79.