



NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

1140 19th Street, NW, Suite 800

Washington, DC 20036

Tel: 202.686.3700

Fax: 202.686.3656

www.nasbp.org

Do Surety Bonds and Trust Arrangements Offer the Same Protection? What Principals, Obligees, and Claimants Need to Know

Various alternatives to surety bonds, particularly to contract surety bonds as performance and payment security on public and private works projects, surface periodically in the marketplace. At such time, those in the surety and construction industries compare the alternative instrument with a contract surety bond, asking such questions as the following: (1) Would the alternative instrument meet statutory bonding requirements? (2) How would the alternative instrument impact the bond principal? (3) How would the alternative instrument impact the bond obligee and/or claimant(s)?

Currently, insurance trust arrangements are being marketed as effective alternatives to surety bonds. The question addressed in this paper is whether an insurance trust arrangement, a so-called "surety trust," is a proper alternative to a surety bond.

First, a surety trust is not an adequate substitute for a statutorily required performance and payment surety bond. Under most, if not all, state bonding statutes, so-called "Little Miller Acts," a surety trust arrangement would not comply with the statutorily required security requirements on public works projects. Where a surety trust arrangement might be considered an alternative to bonds is in the context of private projects. It is imperative, therefore, that principals, obligees, and claimants understand the differences between surety bonds and surety trusts.

A surety trust functions very differently from a surety bond. Under a surety trust, the trust grantor, the trust beneficiary, and the trustee enter into an agreement whereby the grantor deposits cash or assets into a trust for the benefit of the trust beneficiary. There is no prequalification of the grantor; rather, the grantor must deposit cash and/or assets into the trust and name the beneficiary of the trust. In contrast, a thorough prequalification process occurs in the underwriting of a principal for contract surety bonds. A surety bond requires good credit standing and an experienced principal; a surety trust does not. A licensed surety company reviews the creditworthiness, the financial statements, the work program, the banking relationship, and other relevant information concerning the business seeking bonds. In the case of a surety trust, no surety company has underwritten and deemed the company capable of completing the bonded work, by issuing performance and payment bonds.

With a surety trust in lieu of a surety bond, the obligee loses the critical benefit of the surety prequalification process. In addition, a deposit of cash or certain assets into a trust is an unexpected investment for a contractor or subcontractor. Most will

be unable and unwilling to make such a deposit of funds. Contractors need their cash and credit to operate their businesses. Few will have such capacity, and competition would be concomitantly reduced. Those who could make such deposits must leave those deposits in trust for the entirety of the project. Any contractor using its own capital to fund the trust would significantly and unexpectedly tie up its liquidity.

With a surety trust in lieu of a performance bond, the trust is a mechanism by which the owner/obligee can draw down on the trust, similar to the mechanism to draw down on a letter of credit. It is a demand instrument. It is unclear who, if anyone, evaluates the demand. With surety bonds the surety company evaluates the validity of a claim with regard to the principal's obligations under the contract. The surety company will not pay or complete the contract if, after its independent investigation, it determines the principal has no obligation. With a trust arrangement, there is no such analysis and no protection of the principal if the claim is improper. The surety also has various remedies available to cure any legitimate default.

Furthermore, unless stated as beneficiaries, any unpaid claimants, such as subcontractors and suppliers, have no protection under surety trusts from contractor failure to pay for work performed or materials supplied. While a payment bond protects certain unpaid laborers and suppliers, a surety trust would be highly unlikely to provide any protection at all. In many jurisdictions, project funds on publically financed projects are already considered "trust funds" for the benefit of subcontractors and suppliers. A surety trust that does not protect subcontractors and suppliers violates this core principle of the right to be paid on public jobs.

In addition, if an owner/obligee drew down on a surety trust, it would have to administer the remainder of the contract or hire someone to do so, as there would be no surety to step into the shoes of the contractor to complete the contract or arrange for contract completion. In the context of a surety bond, under such circumstances, the surety would be obligated to complete the contract or arrange for its completion. Sureties are well informed and experienced on how best to cure legitimate contract defaults, and they have or engage experts to handle the complexities of construction projects.

As set forth above, there are significant functional differences between a surety bond and a surety trust; and parties considering the use of such products should understand those differences and make informed decisions. If statutory compliance, prequalification process, robust competition, default evaluation, and/or payment protection are important, then surety bonds have distinct advantages over surety trusts.