

## Memorandum 90-74

Subject: Bonds and Undertakings (Limitations on Personal Sureties)

The Bond and Undertaking Law, which appears at Code of Civil Procedure Sections 995.010 to 996.560, was enacted on recommendation of the Law Revision Commission. One aspect of the Bond and Undertaking Law, carried over from preexisting law, allows a statutory bond to be executed by two or more sufficient personal sureties instead of an admitted surety insurer. Code Civ. Proc. § 995.310. Personal sureties are not sufficient unless they are residents and property owners or householders within the state. Their combined net worth, over and above debts and liabilities and exclusive of exempt property, must be twice the amount of the bond. Code Civ. Proc. § 995.510.

Despite these safeguards, personal suretyship is risky for bond and undertaking beneficiaries. Some of the risks are mentioned in Schreiber, Personal Suretyship, 5 Mercer L. Rev. 289, 300 (1954):

If the obligee has accepted personal surety and the surety dies, moves, disposes of his property, becomes insolvent or goes through bankruptcy, then the value of the suretyship has become impaired. There is no safeguard that the personal surety will remain financially responsible during the period of the bond. The obligee does not have a lien on the personal surety's assets until he has a judgment, and the time elapsing after a default and before a judgment can be entered gives the personal surety ample time to dispose of his assets and make himself judgment proof.

For these reasons most states do not allow personal sureties where the beneficiary of the bond or undertaking is the state or a local entity. California, however, allows personal sureties for all statutory bonds, whether the beneficiary is the government or a private individual. This provision can be viewed as a populist measure since personal suretyship is ordinarily gratuitous and avoids the need for payment of premiums to an admitted surety insurer.

Nonetheless, the problems of personal suretyship are real. We have recently been forwarded a letter by former Assemblyman McAlister, who authored the Bond and Undertaking Law for the Commission, from an

Auburn lawyer who correctly points out that under the law, "nothing prevents the declarant from transferring, selling, or otherwise disposing of the property described in the affidavit. If this happens, although the signator may still be personally liable, there is no longer any security which can be executed upon." Exhibit 1 (letter from Douglas G. Busch of Auburn).

Mr. Busch asks whether there is anything that can be done to avoid, or at least minimize, the ability of personal sureties to dispose of the property that has, in effect, been "pledged" as security for their performance. Mr. Busch is not the only person who has asked this question recently. At the federal level, the General Accounting Office (GAO) in October 1989 made a study of individual sureties used to support federal construction contract bonds and found substantial losses and problems resulting from their use.

The GAO has now adopted regulations to attempt to deal with the problems that result from use of individual sureties. As far as we have been able to ascertain, the federal regulations are the first attempt in the United States to do this; we have been able to find no state that seeks to address the problem of insolvent personal sureties.

The GAO regulations were promulgated on November 28, 1989, after prior publication in the Federal Register and after reviewing over 400 comments (split about equally in favor and opposed to the regulations) and after considering the views of Congress. The key to the GAO regulations is the requirement that individual sureties pledge or give a security interest in the assets that qualify them on the bond; this would take the form of an escrow account for liquid assets or a lien on real property. 48 CFR § 28.203-1. The regulations detail the acceptable assets and the manner of valuing them, the type of escrow account, the form of a real property lien, the procedure for substitution of other assets for those pledged on request of the surety, release of liens, and grounds for exclusion of sureties. 48 CFR § 28.203-1, 2, 3, 4, 5, 6, 7. A copy of the GAO regulations is attached as Exhibit 2.

The staff believes that the GAO regulations offer a good basis upon which California might attempt by statute to regulate personal sureties, if necessary. The basic tension here is between the beneficiary's need for security when forced by statute to accept a

personal surety, and a principal's need to be able to provide a bond or undertaking without having to pay an admitted surety insurer for it. The GAO regulations attempt to satisfy these objectives. However, the staff believes as a practical matter the regulations will greatly deter use of personal sureties, to the benefit of the surety industry. Also, at the federal level there was concern that the regulations could hurt small and minority businesses which may rely more on personal sureties.

That having been said, the staff's sense is that the regulations are not unfair. A person's word is not the person's bond, in this instance, and it is proper that the bond or undertaking be backed up by real security. Since the statute requires a beneficiary to accept personal sureties, the statute should also ensure that personal sureties will be sufficient when called upon to perform.

The existing requirement that the sureties be worth twice the amount of the bond is some protection, but not enough. The staff would proceed to draft a statute for California based on the GAO regulations. But since this will yield a personal surety bond or undertaking that is fully secured, the staff would also reduce the number of personal sureties required from two to one and the net value of the personal surety requirement from twice the amount of the bond to equal the amount of the bond.

An alternate approach could be to leave the existing personal surety statute intact, but supplement it with the ability to give a GAO-type secured bond or undertaking using only one surety and requiring security only in the amount of the bond or undertaking. This would not be hugely different from the situation that exists in California right now, since under existing law instead of giving a bond or undertaking the principal can deposit the required amount in liquid assets. Code Civ. Proc. §§ 995.710-.770. This option would in effect add to existing law the ability to give real property security instead of a cash deposit.

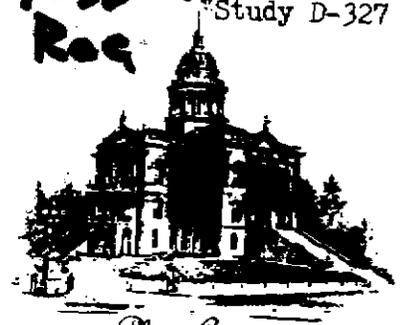
Respectfully submitted,

Nathaniel Sterling  
Assistant Executive Secretary

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December 4, 1989

RE: Statutory Bonds - Assembly Bill 2751  
CCP 995-510; CCP 995-520 and  
Related Sections

Dear Assemblyman McAlister:

Your name and address was provided to me by Assemblyman Tim Leslie, in response to my inquiry regarding the above-referenced code sections.

If my interpretation of such afore-mentioned sections is correct, appropriate personal affidavits can be utilized in lieu of institutional surety bonds. While I do not find that such use is objectionable, if the contents of such affidavits are true at the time of execution, I do have considerable question with such use in actual practical applications.

If I have interpreted the codes correctly, one who is not a party to the litigation, can by declaration, set forth that they are the owners of property of which the unencumbered value exceeds twice the amount of the bond requirements.

After filing of such affidavit, as I read the codes, nothing prevents the declarant from transferring, selling, or otherwise disposing of the property described in the affidavit. If this happens, although the signator may still be personally liable, there is no longer any security which can be executed upon.

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Assemblyman Alister McAlister  
December 4, 1989  
Page -2-

Is there anything which can be done to avoid, or at least minimize, the ability of such sureties to dispose of the property, which has, in effect, been "pledged" as security for their performance?

If I have not interpreted these code sections properly, I would certainly appreciate any clarification you may be able to provide.

Thanking you in advance for your cooperation, I remain,

Very truly yours



Douglas G. Busch  
Attorney at Law

DGB:bb

**28.203 Acceptability of individual sureties.**

(a) An individual surety is acceptable for all types of bonds except position schedule bonds. The contracting officer shall determine the acceptability of individuals proposed as sureties, and shall ensure that the surety's pledged assets are sufficient to cover the bond obligation. (See 28.203-7 for information on excluded individual sureties.)

(b) An individual surety must execute the bond, and the unencumbered value of the assets (exclusive of all outstanding pledges for other bond obligations) pledged by the individual surety, must equal or exceed the penal amount of each bond. The individual surety shall execute the Standard Form 28 and provide a security interest in accordance with 28.203-1. One

individual surety is adequate support for a bond, provided the unencumbered value of the assets pledged by that individual surety equal or exceed the amount of the bond. An offeror may submit up to three individual sureties for each bond, in which case the pledged assets, when combined, must equal or exceed the penal amount of the bond. Each individual surety must accept both joint and several liability to the extent of the penal amount of the bond.

(c) If the contracting officer determines that no individual surety in support of a bid guarantee is acceptable, the offeror utilizing the individual surety shall be rejected as nonresponsible, except as provided in 28.101-4. A finding of nonresponsibility based on unacceptability of an individual surety, need not be referred to the Small Business Administration for a competency review. (See 19.602-1(a)(2)(i) and 61 Comp. Gen. 456 (1982).)

(d) A contractor submitting an unacceptable individual surety in satisfaction of a performance or payment bond requirement may be permitted a reasonable time, as determined by the contracting officer, to substitute an acceptable surety for a surety previously determined to be unacceptable.

(e) When evaluating individual sureties, contracting officers may obtain assistance from the office identified in 28.202(d).

(f) Contracting officers shall obtain the opinion of legal counsel as to the adequacy of the documents pledging the assets prior to accepting the bid guarantee and payment and performance bonds.

(g) Evidence of possible criminal or fraudulent activities by an individual surety shall be referred to the appropriate agency official in accordance with agency procedures.

39. Section 28.203-1 is added to read as follows:

**28.203-1 Security interests by an individual surety.**

(a) An individual surety may be accepted only if a security interest in assets acceptable under 28.203-2 is provided to the Government by the individual surety. The security interest shall be furnished with the bond.

(b) The value at which the contracting officer accepts the assets pledged must be equal to or greater than the aggregate penal amounts of the bonds required by the solicitation and may be provided by one or a combination of the following methods:

(1) An escrow account with a federally insured financial institution in the name of the contracting agency. (See 28.203-2(b)(2) with respect to Government securities in book entry form.) Acceptable securities for deposit in escrow are discussed in 28.203-2. While the offeror is responsible for establishing the escrow account, the terms and conditions must be acceptable to the contracting officer. At a minimum, the escrow account shall provide for the following:

(i) The account must provide the contracting officer the sole and unrestricted right to draw upon all or any part of the funds deposited in the account. A written demand for withdrawal shall be sent to the financial institution by the contracting officer, after obtaining the concurrence of legal counsel, with a copy to the offeror/contractor and to the surety. Within the time period specified in the demand, the financial institution would pay the Government the amount demanded up to the amount on deposit. If any dispute should arise between the Government and the offeror/contractor, the surety, or the subcontractors or suppliers with respect to the offer or contract, the financial institution would be required, unless precluded by order of a court of competent jurisdiction, to disburse monies to the Government as directed by the contracting officer.

(ii) The financial institution would be authorized to release to the individual surety all or part of the balance of the escrow account, including any accrued interest, upon receipt of written authorization from the contracting officer.

(iii) The Government would not be responsible for any costs attributable to the establishment, maintenance, administration, or any other aspect of the account.

(iv) The financial institution would not be liable or responsible for the interpretation of any provisions or terms and conditions of the solicitation or contract.

(v) The financial institution would provide periodic account statements to the contracting officer.

(vi) The terms of the escrow account could not be amended without the consent of the contracting officer.

(2) A lien on real property, subject to the restrictions in 28.203-2 and 28.203-3.

40. Section 28.203-2 is redesignated as 28.204-2 and new section 28.203-2 is added to read as follows:

**28.203-2 Acceptability of assets.**

(a) The Government will accept only cash, readily marketable assets, or irrevocable letters of credit from a federally insured financial institution

from individual sureties to satisfy the underlying bond obligations.

(b) Acceptable assets include—

(1) Cash, or certificates of deposit, or other cash equivalents with a federally insured financial institution;

(2) United States Government securities at market value. (An escrow account is not required if an individual surety offers Government securities held in book entry form at a depository institution. In lieu thereof, the individual shall provide evidence that the depository institution has (i) placed a notation against the individual's book entry account indicating that the security has been pledged in favor of the respective agency; (ii) agreed to notify the agency prior to maturity of the security; and (iii) agreed to hold the proceeds of the security subject to the pledge in favor of the agency until a substitution of securities is made or the security interest is formally released by the agency;

(3) Stocks and bonds actively traded on a national U.S. security exchange with certificates issued in the name of the individual surety. National security exchanges are—(i) the New York Stock Exchange; (ii) the American Stock Exchange; (iii) the Boston Stock Exchange; (iv) the Cincinnati Stock Exchange; (v) the Midwest Stock Exchange; (vi) the Philadelphia Stock Exchange; (vii) the Pacific Stock Exchange; and (viii) the Spokane Stock Exchange. These assets will be accepted at 90 percent of their 52-week low, as reflected at the time of submission of the bond. Stock options and stocks on the over-the-counter (OTC) market or NASDAQ Exchanges will not be accepted. Assistance in evaluating the acceptability of securities may be obtained from the Securities and Exchange Commission, Division of Enforcement, 450 Fifth Street NW., Washington, DC 20549.

(4) Real property owned in fee simple by the surety without any form of concurrent ownership, except as provided in subdivision (c)(3)(iii) of this subsection, and located within the 50 United States, its territories, or possessions. These assets will be accepted at 100 percent of the most current tax assessment value (exclusive of encumbrances) or 75 percent of the properties' unencumbered market value provided a current appraisal is furnished (see 28.203-3).

(5) Irrevocable letters of credit (ILC) issued by a federally insured financial institution in the name of the contracting agency and which identify the agency and solicitation or contract number for which the ILC is provided.

(c) Unacceptable assets include but are not limited to—

(1) Notes or accounts receivable;

(2) Foreign securities;

(3) Real property as follows:

(i) Real property located outside the United States, its territories, or possessions.

(ii) Real property which is a principal residence of the surety.

(iii) Real property owned concurrently regardless of the form of co-tenancy (including joint tenancy, tenancy by the entirety, and tenancy in common) except where all co-tenants agree to act jointly.

(iv) Life estates, leasehold estates, or future interests in real property.

(4) Personal property other than that listed in paragraph (b) of this subsection (e.g., jewelry, furs, antiques);

(5) Stocks and bonds of the individual surety in a controlled, affiliated, or closely held concern of the offeror/contractor;

(6) Corporate assets (e.g., plant and equipment);

(7) Speculative assets (e.g., mineral rights);

(8) Letters of credit, except as provided in 28.203-2(b)(5).

41. Sections 28.203-3 through 28.203-7 are added to read as follows:

**28.203-3 Acceptance of real property.**

(a) Whenever a bond with a security interest in real property is submitted, the individual surety shall provide—

(1) Evidence of title in the form of a certificate of title prepared by a title insurance company approved by the United States Department of Justice.

This list entitled *List of Approved Attorneys, Abstracters, and Title Companies* is available from the Title Unit, Land Acquisition Section, Land and Natural Resource Division, Department of Justice, Washington, DC 20530. This title evidence must show fee simple title vested in the surety along with any concurrent owners; whether any real estate taxes are due and payable; and any recorded encumbrances against the property, including the lien filed in favor of the Government under paragraph (d) of this subsection.

(2) Evidence of the amount due under any encumbrance shown in the evidence of title;

(3) A copy of the current real estate tax assessment of the property or a current appraisal dated no earlier than 6 months prior to the date of the bond, prepared by a professional appraiser who certifies that the appraisal has been conducted in accordance with the generally accepted appraisal standards as reflected in the Uniform Standards of

Professional Appraisal Practice as promulgated by the Appraisal Foundation, 1029 Vermont Avenue NW, Washington, DC 20005.

(b) Failure to provide evidence that the lien has been properly recorded will render the offeror nonresponsible.

(c) The individual surety is liable for the payment of all administrative costs of the Government, including legal fees, associated with the liquidation of pledged real estate.

(d) The following format, or any document substantially the same, shall be used by the surety and recorded in the local recorder's office when a surety pledges real estate on Standard Form 28, Affidavit of Individual Surety.

**Lien on Real Estate**

I/we agree that this instrument constitutes a lien in the amount of \$\_\_\_\_\_ on the property described in this lien. The rights of the United States Government shall take precedence over any subsequent lien or encumbrance until the lien is formally released by a duly authorized representative of the United States. I/we hereby grant the United States the power of sale of subject property, including the right to satisfy its reasonable administrative costs, including legal fees associated with any sale of subject property, in the event of contractor default if I/we otherwise fail to satisfy the underlying ( ) bid guarantee, ( ) performance bond, ( ) or payment bond obligations as an individual surety on solicitation/contract number \_\_\_\_\_. The lien is upon the real estate now owned by me/us described as follows: (legal description, street address and other identifying description)

IN WITNESS HEREOF, I/we have hereunto affixed my/our hand(s) and seal(s) this \_\_\_\_\_ DAY OF \_\_\_\_\_ 19\_\_\_\_

WITNESS: \_\_\_\_\_

(SEAL)

I, \_\_\_\_\_, a Notary Public in and for the (CITY) \_\_\_\_\_, (STATE) \_\_\_\_\_, do hereby certify that \_\_\_\_\_, a party or parties to a certain Agreement bearing the date \_\_\_\_\_ day of \_\_\_\_\_ 19\_\_\_\_, and hereunto annexed, personally appeared before me, the said \_\_\_\_\_ being personally well known to me as the person(s) who executed said lien, and acknowledged the same to be his/har/their act and deed. GIVEN under my hand and seal this \_\_\_\_\_ day of \_\_\_\_\_ 19\_\_\_\_

NOTARY PUBLIC, STATE \_\_\_\_\_  
My Commission expires:

**28.203-4 Substitution of assets.**

An individual surety may request the Government to accept a substitute asset for that currently pledged by submitting a written request to the responsible contracting officer. The contracting officer may agree to the substitution of assets upon determining, after consultation with legal counsel, that the substitute assets to be pledged are adequate to protect the outstanding bond or guarantee obligations. If acceptable, the substitute assets shall be pledged as provided for in Subpart 28.2

**28.203-5 Release of lien.**

(a) After consultation with legal counsel, the contracting officer shall release the security interest on the individual surety's assets using the Optional Form 90, Release of Lien on Real Property, or Optional Form 91, Release of Personal Property from Escrow, or a similar release as soon as possible consistent with the conditions in subparagraphs (a) (1) and (2) of this subsection. A surety's assets pledged in support of a payment bond may be released to a subcontractor or supplier upon Government receipt of a Federal district court judgment, or a sworn statement by the subcontractor or supplier that the claim is correct along with a notarized authorization of the release by the surety stating that it approves of such release.

(1) *Contracts subject to the Miller Act.* The security interest shall be maintained for the later of (i) 1 year following final payment, (ii) until completion of any warranty period (applicable only to performance bonds), or (iii) pending resolution of all claims filed against the payment bond during the 1-year period following final payment.

(2) *Contracts not subject to the Miller Act.* The security interest shall be maintained for 90 days following final payment or until completion of any warranty period (applicable only to performance bonds), whichever is later.

(b) Upon written request, the contracting officer may release the security interest on the individual surety's assets in support of a bid guarantee based upon evidence that the offer supported by the individual surety will not result in contract award.

(c) Upon written request by the individual surety, the contracting officer may release a portion of the security interest on the individual surety's assets based upon substantial performance of the contractor's obligations under its performance bond. Release of the security interest in support of a payment bond must comply with the subparagraphs (a) (1) and (2) of this

subsection. In making this determination, the contracting officer will give consideration as to whether the unreleased portion of the lien is sufficient to cover the remaining contract obligations, including payments to subcontractors and other potential liabilities. The individual surety shall, as a condition of the partial release, furnish an affidavit agreeing that the release of such assets does not relieve the individual surety of its obligations under the bond(s).

**28.203-8 Contract clause.**

Insert the clause at 52.228-11 in solicitations and contracts which require the submission of bid guarantees, performance, or payment bonds.

**28.203-7 Exclusion of individual sureties.**

(a) An individual may be excluded from acting as a surety on bonds submitted by offerors on procurement by the executive branch of the Federal Government, by the acquiring agency's head or designee utilizing the procedures in Subpart 9.4. The exclusion shall be for the purpose of protecting the Government.

(b) An individual may be excluded for any of the following causes:

(1) Failure to fulfill the obligations under any bond.

(2) Failure to disclose all bond obligations.

(3) Misrepresentation of the value of available assets or outstanding liabilities.

(4) Any false or misleading statement, signature or representation on a bond or affidavit of individual suretyship.

(5) Any other cause affecting responsibility as a surety of such serious and compelling nature as may be determined to warrant exclusion.

(c) An individual surety excluded pursuant to this subsection shall be included on the list entitled Parties Excluded from Procurement Programs. (See 9.404.)

(d) Contracting officers shall not accept the bonds of individual sureties whose names appear on the list entitled Parties Excluded from Procurement Programs (see 9.404) unless the acquiring agency's head or a designee states in writing the compelling reasons justifying acceptance.

(e) An exclusion of an individual surety under this subsection will also preclude such party from acting as a contractor in accordance with Subpart 9.4.

**28.204-1 [Amended]**

42. Section 28.204-1, as redesignated from 28.203-1, is amended by removing in the first sentence the citation "8 U.S.C. 15" and inserting in its place "31 U.S.C. 9303"; and by removing the date "February 8, 1935" and inserting in its place "July 1, 1978".

43. Section 28.204-2, as redesignated from 28.203-2, is amended by revising the section heading to read as follows:

**28.204-2 Certified or cashiers checks, bank drafts, money orders, or currency.**



59. Section 52.228-11 is added to read as follows:

**52.228-11 Pledges of Assets.**

As prescribed in 28.203-8, insert the following clause:

**Pledges of Assets (February 1990)**

(a) Offerors shall obtain from each person acting as an individual surety on a bid guarantee, a performance bond, or a payment bond—

(1) Pledge of assets; and  
(2) Standard Form 28, Affidavit of Individual Surety.

(b) Pledges of assets from each person acting as an individual surety shall be in the form of—

(1) Evidence of an escrow account containing cash, certificates of deposit, commercial or Government securities, or other assets described in FAR 28.203-2 (except see 28.203-2(b)(2) with respect to Government sureties held in book entry form) and/or

(2) A recorded lien on real estate. The offeror will be required to provide—

(i) Evidence of title in the form of a certificate of title prepared by a title insurance company approved by the United States Department of Justice. This title evidence must show fee simple title vested in the surety along with any concurrent owner; whether any real estate taxes are due and payable; and any recorded encumbrances against the property, including the lien filed in favor of the Government as required by FAR 28.203-3(d);

(ii) Evidence of the amount due under any encumbrance shown in the evidence of title;

(iii) A copy of the current real estate tax assessment of the property or a current appraisal dated no earlier than 6 months prior to the date of the bond, prepared by a professional appraiser who certifies that the appraisal has been conducted in accordance with the generally accepted appraisal standards as reflected in the Uniform Standards of Professional Appraisal Practice, as promulgated by the Appraisal Foundation.

(End of clause)



51.228 Bonds and insurance (SF's 24, 25, 25-A, 25-B, 28, 34, 35, 273, 274, 275, 1414, 1415, 1418, OF's 90 and 91).

(a) SF 24 (REV. X/XX), Bid Bond. (See 28.106-1.)

(b) SF 25 (REV. X/XX), Performance Bond. (See 28.106-1(b).)

(c) SF 25-A (REV. X/XX), Payment Bond. (See 28.106-3(c).)

(e) SF 28 (REV. X/XX), Affidavit of Individual Surety. (See 28.106-1(e) and 28.203(b).)

(f) SF 34 (REV. X/XX), Annual Bid Bond. (See 28.106-1(f).)

(g) SF 35 (REV. X/XX), Annual Performance Bond. (See 28.106-1.)

(m) SF 1416 (REV. X/XX), Payment Bond for Other than Construction Contracts. (See 28.106-1(m).)

(n) OF 90 (REV. X/XX), Release of Lien on Real Property. (See 28.106-1(n) and 28.203-5(a).)

(o) OF 91 (REV. X/XX), Release of Personal Property from Escrow. (See 28.106-1(o) and 28.203-5(a).)

111. Section 53.301-1413 is revised to read as follows:

**53.301-1413 Standard Form 1413, Statement and Acknowledgment.**

BILLING CODE 5020-JC-11

