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11/05/90

Memorandum 90-86

Subject: Bonds and Undertakings (Limitations on Personal Sureties)

Background

At the May/June meeting the Commission considered a letter from an Auburn lawyer concerned about personal sureties on a bond or undertaking who had insufficient assets when the time came to collect on the bond. The lawyer correctly pointed out that the bond and undertaking law requires personal sureties to have sufficient assets initially, but once the bond is issued the personal sureties may dispose of their qualifying assets or become insolvent, and then the bond may become worthless. The lawyer asked whether there is anything that can be done to avoid, or at least minimize, the ability of personal sureties to dispose of property that has, in effect, been "pledged" as security for their performance.

The federal government has recently been involved with the same issue. The General Accounting Office 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. GAO has now adopted regulations to attempt to deal with the problems that result from use of individual sureties. 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.

The staff indicated at the May/June meeting that it believes the GAO regulations offer a good basis upon which California might attempt

by statute to regulate personal sureties, if necessary. The Commission decided first to investigate whether there has been a significant problem in practice in California.

Extent of Problem in California

The Commission directed the staff to solicit input on this matter from the State Bar committees most likely to be involved with personal sureties--those involved with probate bonds, appeal bonds, creditor bonds, and public contract bonds. The staff wrote to each of the relevant committees requesting information about the use of personal sureties in the field and any problems experienced in collecting from personal sureties.

We wrote four months ago but have received no response from any of the State Bar committees. Some may meet infrequently; others may have concern with the Keller decision. In any event, we have no additional information from this source.

The Commission also directed the staff to solicit input from state agencies that frequently deal with bonds. This approach proved fruitful, and we have received letters from the Department of General Services and the Department of Transportation, copies of which are attached to this memorandum. The chief counsel for General Services states that he does not recall a single personal surety being offered in his 33 years of experience in state government, nor has he heard of problems with personal sureties. The Department of Transportation has limited experience with personal sureties, since most of the statutes and regulations they operate under require admitted surety insurers. The assistant chief counsel for that agency does recall at least one instance where individual sureties were inadvertently accepted on a construction contract. "In that case, the sureties failed to respond to claims made against the bond."

We have also spoken with the county counsel's office in Kern County; the board of supervisors of that county has taken the position that it will no longer accept personal sureties due to problems with the assets being used to qualify the sureties. Many of the assets are encumbered, their value is not readily ascertainable, and some types of qualifying property have been "bizarre". Personal suretyship is to

some extent a business, and a number of personal sureties who used to be involved with federal bonds have now moved operations into California because it is one of the few states that allows personal sureties.

Conclusion

We have managed to gather very little data about the extent of the personal surety problem in California. There are certainly some instances where problems do arise; in fact, that is what prompted the letter we received from the Auburn lawyer concerned about the inability of the personal sureties to make good on the bond in his case.

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 relay more on personal sureties.

All things considered, the staff's sense is that the GAO 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 California statute requires a beneficiary to accept personal sureties, the statute should also ensure that personal sureties will be sufficient when called upon to perform. Any change in law to require security of personal sureties should include a corresponding reduction in the number of personal sureties required from two to one and in 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

STATE OF CALIFORNIA—BUSINESS, TRANSPORTATION AND HOUSING AGENCY GEORGE DEUKMEJIAN, Governor

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September 4, 1990

Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Comm.
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

Dear Mr. Sterling:

In re: Individual Sureties

The following comments are offered in response to your letter of August 13, 1990, regarding the above subject.

The majority of our projects are under the State Contract Act, which requires that bidders' bonds, performance bonds, and payment bonds be executed by an admitted surety insurer. See Public Contract Code sections 10167 and 10221. We have refused to accept the infrequent bid bonds written by individual sureties. Two years ago, a bidder unsuccessfully argued that federal law, specifically 48 C.F.R. section 28.201-2 of the Federal Acquisition Regulations, preempted state law with respect to the acceptability of individual sureties for federal-aid contracts. I am aware of at least one instance when individual sureties were inadvertently accepted on a construction contract. In that case, the sureties failed to respond to claims made against the bond.

In those cases where state law does not specifically require that a bond be executed by an admitted surety insurer, it has been the practice of this department to require that bonds be so executed.

The current concern of the Federal Government over problems resulting from the use of individual sureties has resulted in modification of the above-cited Federal Acquisition Regulation, effective February 26, 1990. See 54 F.R. 48978, 48986-48989 (Nov. 28, 1989). The Federal Acquisition Regulations now

require, among other things, that unencumbered assets of the individual surety be pledged to the government in an amount at least equal to the penal amount of the bond, and that, as to real property, a lien be recorded. The reason for the amendment of the Federal Acquisition Regulations was stated in the Notice of Proposed Rulemaking, 53 F.R. 44564 (Nov. 3, 1988):

> "Based upon recent experience with the use of individual sureties, it has been determined that existing FAR coverage concerning individual sureties is inadequate to ensure that the interests of the Government and suppliers under Government contracts which require a payment bond, are protected. A task force established by the Civilian Agency Acquisition Council and the Defense Acquisition Regulatory Council found widespread evidence of systematic problems with the current method of handling individual sureties. Also, see the report of Senate Hearing 100-384 before the Subcommittee on Federal Spending, Budget and Accounting of the Committee on Governmental Affairs entitled Personal Sureties Under the Miller Act: Inadequate Payment Protection for Small Business Construction Subcontractors."

There are a number of concerns which would be raised by the use of individual sureties. These include questions of how to enforce the obligation against nonresident individuals, whether an individual surety would be able to cause the work of a defaulted contract to be completed, and how the listed assets of the proposed surety would be verified. The factors which an underwriter must consider in evaluating the risk involved in writing a contract bond can be very complex. See California Surety and Fidelity Bond Practice, CEB (1969) pp. 153-156. Whether an individual would be equipped to perform that evaluation would be of concern, particularly to this department, which no longer prequalifies contractors under the State Contract Act.

The administrative burden of investigating each proposed individual surety would be considerable. For an example of the type of question encountered by the Federal Government, see Comptroller General Decision B-236927 (Jan. 23, 1990), affirmed on rehearing, B-236927.2 (Apr. 25, 1990). In that matter, an individual surety was found unacceptable because of failure to produce an acceptable escrow agreement.

I am informed that the County of Kern has had some experience with individual sureties. You may want to contact the county for further information.

If I can be of further assistance, please do not hesitate to contact me.

Very truly yours,

RICHARD W. BOWER
Assistant Chief Counsel

State of California
Memo 90-86
Memorandum

State and Consumer Services Agency
Study D-327

Date : August 24, 1990

File No.:

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AUG 27 1990
RECEIVED

To : Nathaniel Sterling
Assistant Executive Secretary
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From : Department of General Services

Subject : SURETIES FOR BONDS

Your August 13 memo made inquiry about our experience with regard to personal sureties for bonds or undertakings offered to the State. From my limited exposure the use of personal sureties in State business is very limited. In fact I don't recall a single instance where such a bond or undertaking was tendered nor have I heard of any difficulty encountered in connection with such. My background reviewing contracts in State government as an attorney spans over 33 years.

Charles O. Thrasher
Chief Counsel
Office of Legal Services

COT:tm