SFAA Testimony Opposing SB 372
Senate Finance Committee
February 3, 2021

Honorable Committee Members,

The Surety & Fidelity Association of America ("SFAA") is a non-profit corporation whose member companies collectively write the vast majority of surety and fidelity bonds in the United States. SFAA is a licensed rating/ advisory organization in all states and is designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience.

Respectfully, SFAA strongly encourages policymakers to oppose MD SB 372, legislation that would apply bad faith standards to writers of surety bonds for the reasons below.

Bad Faith Actions are Inappropriate for Surety Claims

The factors that lead many states to impose bad faith damages on insurers do not apply to surety bonds. There are no contracts of adhesion, individual claimants unable to protect themselves, or unequal bargaining power in the surety bond landscape. In recognition of this fact, most states that impose bad faith liability on insurers appropriately exempt surety bonds.

Judicial Exemptions for Surety

In some states bad faith is imposed on insurers by judicial decision, and the exemption of surety is often articulated by the courts. For example, in Cates Construction, Inc. v. Talbot Partners, 980 P.2d 407 (Cal. 1999), the California Supreme Court stated at 980 P.2d 427:

A construction performance bond is not an insurance policy. Nor is it a contract otherwise marked by elements of adhesion, public interest or fiduciary responsibility, such that an extracontractual remedy is necessitated in the interests of social policy.

Similarly, in Great American Ins. Co. v. North Austin Municipal Utility District No. 1,908 S.W.2d 415, 418 (Tex. 1995), the Texas Supreme Court stated:

Second, concerns that a surety may take advantage of a bond obligee in the claims resolution process ignore the fundamental differences between a liability insurance contract and a surety bond. While a liability insurance contract involves only two parties, the insurer and the insured, suretyship involves a tripartite relationship between a surety, its principal, and the bond obligee, in which the obligation of the surety is intended to supplement an obligation of the principal owed to the bond obligee.

Statutory Exemptions for Surety

In states that mandate bad faith damages against insurers by statute, sureties are routinely exempted. For example, Section 624.155, Florida Statutes, grants a cause of action against an insurer for bad faith failure to pay, but it specifically exempts surety bonds. Subsection (9) states, "A surety issuing a payment or performance bond on the construction or maintenance of a building or roadway project is not an insurer for purposes of subsection (1)"

In Pennsylvania, 42 Pa. Cons. Stat. Ann. §8371 provides remedies for bad faith by an insurer toward an insured. Courts in Pennsylvania have consistently held that there is no cause of action against a surety under section 8371. See, for example, Superior Precost, Inc. v. Safeco Ins. Co. of America, 71 F. Supp.2d 438, 448-454 (E.D. Pa. 1999).

Practical Application

A surety is often caught in the middle of a dispute between its principal and the claimant. The principal will have to reimburse the surety in the case of a loss and vehemently argues that the claim is not valid. The claimant equally emphatically argues that the principal owes it the amount claimed and that the claim is valid. Legislation providing for a bad faith cause of action against sureties would force the surety to either pay the claim at the principal's expense or risk bad faith damages. The impact of such bills becoming law is that one can assume that every surety claim in the state will include an automatic bad faith allegation.

Even in cases where the surety ultimately prevails, the bad faith claim will add to the cost of handling the claim-and any litigation. Most bonds are required by statute to serve a public purpose. The increased costs resulting from such legislation would ultimately fall on the public in the form of higher costs to the bond principal and the surety. These higher costs would be passed on to the public. For example, many state laws require bonds from contractors on public works. Those contractors would include the cost of the bonds in their bids. If the contractor/bond principal and the surety have to pay to defend even invalid bad faith claims, those costs will increase.

Summary

Legislation that does not recognize that the bond principal is a party to the bond and primarily obligated to pay anything owed under the bond won't benefit the bond holders or the public. The bond principal-- most commonly a construction contractor -- will pay the costs and damages. The surety will be liable as a guarantor if the principal is unable to pay, but the primary obligation is the principal's. That is one of the fundamental differences between bonds and insurance policies--and one of the many reasons why such legislation is ill-advised.

Respectfully,

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