

SURETY BONDS - BACKGROUND MEMORANDUM

House Bill No. 1386, Section 1 (attached as Appendix A), directs a study of:

1. North Dakota Century Code (NDCC) provisions requiring public officers and other individuals and entities to provide bonds.
2. Whether the state bonding fund is an appropriate entity to provide those bonds.
3. Whether private entities within the state provide bonds for public officials and other individuals and entities required to be bonded.
4. Whether the bonds required by statute are appropriate and necessary.

As introduced, the bill expanded the public employees that are bonded under the state bonding fund to include any employee or official required by statute to provide a bond. This change would have included a person employed by an occupational and professional board or commission in coverage under the state bonding fund. The bill also would have required a public employee who elected to purchase a bond from a surety company, instead of being bonded by the state bonding fund, to purchase the bond from a company located within this state. The legislative history reveals that the bill was introduced to address the problem of auctioneers and auctioneer clerks being able to secure a bond from out of state. The solution was to have a state bonding fund provide the bond, thereby keeping the fee for the bond in this state.

BONDING OF PUBLIC EMPLOYEES AND LICENSEES

Generally, there are two separate groups of people which are required by law to be bonded--public employees and licensees. Although a public employee may be bonded through a surety company under NDCC Section 26.1-21-23 and personally pay for the bond, most public employees are bonded through the state bonding fund. In addition, under Section 26.1-21-19 the Insurance Commissioner may cancel the liability of the fund for the act of an employee or official. In this case, the official or employee may secure, at personal expense, a bond executed by a surety company.

Upon application and approval by the Insurance Commissioner, the state bonding fund provides a fidelity bond to public employees and public officials. Under NDCC Section 26.1-21-01 a public employee is any person employed by the state or any of its political subdivisions, officers and employees of a nonprofit organization providing services and programs for senior citizens, the treasurer and district employees of a water resource district, and an officer or employee of the International Peace Garden. The term "public employee" does not include a person employed by an occupational or professional board or commission or the State Bar Association. A public official is any officer or deputy required to be bonded by law except for an officer of an

occupational or professional board or commission, or the State Bar Association. The term "state" means the state departments, agencies, industries, and institutions and the International Peace Garden. The term "political subdivision" means all counties, townships, park districts, school districts, cities, and any other unit of local government which is created either by statute or by the Constitution of North Dakota for local government or other public purposes.

Under NDCC Section 26.1-21-06 the bond provided by the state bonding fund is limited to that of a fidelity bond, unless otherwise provided by statute. Black's Law Dictionary, 6th Edition, defines a fidelity bond as a bond covering an employer for loss due to embezzlement, larceny, or gross negligence by employees. Under Section 26.1-21-07 coverage under the fund is determined by the Insurance Commissioner based upon money or property handled and the opportunity for defalcation. However, the commissioner may not set the coverage less than otherwise required by law. Black's Law Dictionary, 6th Edition, defines defalcation as the act of embezzling; the failure to meet an obligation; the misappropriation of money held in any fiduciary capacity; and the failure to properly account for these funds.

Under NDCC Section 26.1-21-02 the state bonding fund is managed by the Insurance Commissioner. Under Section 26.1-21-04 the Attorney General is the attorney for the Insurance Commissioner in matters relating to the fund. Under Section 26.1-21-05 the fund is invested by the State Investment Board.

Under NDCC Section 26.1-21-09 the Insurance Commissioner determines the premium for the bond. The premiums are paid to the State Treasurer. Since 1953 the premiums have been waived until the reserve fund of the state bonding fund has been deleted below the sum of \$2.5 million. A premium has not been charged for coverage since 1953.

Under NDCC Section 26.1-21-11 claims on the bond must be presented to the Insurance Commissioner within 60 days after discovery of the default or wrongful act. Under Section 26.1-21-13 all liability claims against the funds must be audited by the Insurance Commissioner. The Attorney General must approve the audit. Under Section 26.1-21-14 an action may not be maintained against the fund on a claim unless the claim first has been presented for allowance and the allowance of the claim has been refused. Under Section 26.1-21-17 all liability claims paid from the fund must be paid by the State Treasurer upon warrants prepared by the Office of Management and Budget pursuant to the directions of the Insurance Commissioner.

In 2003 Senate Bill No. 2185 repealed NDCC Sections 44-01-08, 44-01-09, and 44-01-10. These sections applied when a public officer gave a bond other than one by the state bonding fund. Under Section 44-01-08 the bond must have been approved by the

Governor as to its sufficiency and the Attorney General as to its form if the bond were given by a state officer, and approved as to its sufficiency by the board of county commissioners or other governing body and to form by the state's attorney if the bond were given to an officer of a county or other political subdivision. Under Section 44-01-09 the bond of a state or district officer must have been filed with the Secretary of State, and the bond of any officer must have been filed with the county recorder.

According to the Secretary of State these sections were repealed because they were obsolete. They were obsolete because the Secretary of State's office never filed these bonds. In addition, a survey conducted by the Secretary of State's office of this state's 53 county recorders found that of the 21 recorders that responded, only one of them found evidence of a bond filing and that filing occurred in the 1930s. Although the Secretary of State no longer has the duty to file bonds under NDCC Section 44-01-09, under Section 54-09-02 the Secretary of State is required to:

Record and maintain records of the official bond of any state official who furnishes in lieu of the bond furnished by the state bonding fund a bond by a duly authorized surety company.

In 1999 Senate Bill No. 2360 removed a number of requirements on state officials and employees of furnishing a bond in a particular amount. The legislative history reveals that the reason for the removal was that the bonds required by these statutes were separate from the bond provided by the state bonding fund. There was no way of knowing if these other types of bonds had been purchased by the various state agencies or political subdivisions. In addition, testimony stated the bonding requirements were removed because the person being bonded was already covered by the state bonding fund. It is interesting to note that under NDCC Section 26.1-21-10 the provisions of the chapter on state bonding "and of any statute requiring a bond constitute the bond of each and every public official for the purpose of any law of this state requiring such bond and constitute the entire contract between the fund and the state or its political subdivisions, respectively, as the obligee in any such bond."

Senate Bill No. 2360 removed the bonding requirement for the following people:

1. The superintendent of the North Dakota Youth Correctional Center, the warden, and deputy wardens.
2. The commissioner of University and School Lands and the deputy commissioner.
3. The State Fire Marshal and each of the marshal's deputies.
4. The deputy director and chief game warden of the Game and Fish Department.
5. The superintendents of the State Hospital, the Developmental Center at Westwood Park, Grafton, the School for the Blind, and the School for the Deaf.
6. The clerk of the Supreme Court.

7. The commissioner of Veterans Affairs and the commandant of the Veterans Home.
8. Highway patrolmen.
9. The deputies appointed by the Secretary of State, State Auditor, State Treasurer, Superintendent of Public Instruction, Insurance Commissioner, Agriculture Commissioner, Labor Commissioner, district assessors, and city assessors.
10. The public service commissioners.
11. Any replacement State Treasurer.
12. The director of the Department of Corrections and Rehabilitation.
13. The director of the Office of Management and Budget.
14. The executive director of the Public Employees Retirement System Board.
15. The superintendent of the State Historical Society.
16. The State Engineer.
17. The director of Workforce Safety and Insurance and the State Treasurer as custodian of the Workforce Safety and Insurance fund.
18. The commissioner of the Department of Financial Institutions and each of the commissioner's deputies.
19. The treasurer of the North Dakota State University of Agriculture and Applied Science.
20. Each deputy game warden.
21. Any state officer if present bond deemed insufficient by Governor.
22. Each state officer not otherwise required to provide bond.
23. The Secretary of State.
24. The State Auditor.
25. The State Treasurer.
26. Officers and employees of the North Dakota Mill and Elevator Association engaged in financial functions.
27. The state Tax Commissioner.

State law also requires that certain persons be bonded to be licensed to engage in certain kinds of work. For example, NDCC Section 55-08-05 requires concessionaires in state parks to be bonded in an amount determined by the director of the Parks and Recreation Department. In addition, many cities require certain persons to be licensed to engage in certain kinds of work. For instance, the City of Bismarck requires concrete companies to be bonded to work on sidewalks that are in the city right of way. These persons must obtain bonds at their personal expense from the private surety bond market. Premiums and availability of bonds in the private market are determined by the type of activity to be bonded. Generally, surety bonds may be obtained through insurance companies located in this state.

A surety bond is a three-party agreement in which the issuer of the bond, the surety, joins with the second party, the principal, in guaranteeing to a third party, the obligee, the fulfillment of an obligation on the part of the

principal. The obligee is given the benefit of the bond and is protected by the bond against loss.

The reasons for requiring surety bonds from licensees can be divided between the intended beneficiary of the bonds--consumers and the governmental entity. Consumers are protected because they can make a direct claim to the surety company if the licensee acts contrary to the law or the work is not completed in a workmanlike manner. Generally, insurance cannot cover code violations. Insurance covers liability caused by damage to property or to persons. Bonds may cover code violations.

The bonding of licensees provides a benefit to governmental entities because most licenses are conditioned on having a bond. If the bond is revoked, then the person is no longer licensed by the governmental entity. Bonding companies encourage compliance with applicable laws and have the option to withdraw a bond if there is a deficiency or noncompliance. This aids the governmental entity in the enforcement of its laws. In addition, before a bonding company will issue a licensee a bond, the bonding company will conduct an investigation of the licensee's financial and technical ability. Because the bonding company has the right of recourse against a bonded person who has a claim on the bond, the bonding company needs to ensure that the licensee can be financially responsible for the amount of the bond.

Appendix B is a table of surety and similar bonds required in this state. The table does not include bonds of indebtedness, bonds required in a criminal action, bonds required in a civil action, including bonds for appeals, injunctions, or certain remedies. The table lists the information contained in the statute and does not extrapolate. For example, the type of bond may be apparent; however, if the statute said the person must have a bond, the type of bond column is left blank.

The table uses the following terms. The terms are defined as follows:

- A bid or **bidder's bond** is a bond that guarantees that a contractor will enter a contract at the amount bid and post the appropriate performance bonds. These bonds provide financial assurance that the bid has been submitted in good faith and that the contractor will enter the contract at the price bid.
- **Commercial bonds** are a general classification of bonds that refer to all bonds other than contract and performance bonds.
- A **contract bond** is a general classification of bonds that are designed to guarantee the performance of an obligation under a contract. These bonds guarantee the obligee that the principal will perform according to the terms of the written contract. Construction contracts constitute most of these bonds.
- **Fidelity bonds** are designed to guarantee honesty. Generally, the bond guarantees honesty of employees and covers losses arising from employee dishonesty and indemnifies the

principal for losses caused by the dishonest actions of the principal's employees.

- **Insurance** is an indemnification contract for the person being insured. In other words, the insurance company reimburses the insured person thereby holding the person harmless in event of a loss. Bonding is different than insurance. A surety bond is a promise to the person making the claim on the bond.
- A **performance bond** guarantees performance of the terms of a contract. The bond protects the owner from financial loss should the contractor fail to perform the contract in accordance with the contract's terms.
- An **undertaking** is distinguished from a bond in that a bond binds a signatory to pay a sum certain upon the happening of an event, and an undertaking is an obligation in writing binding the signatories to pay such an amount if it is adjudged due. An undertaking with security is a bond. An undertaking has to do with amounts to be determined, and a bond has to do with liquidated amounts.

SUGGESTED STUDY APPROACH

At the beginning of this memorandum there is a list of four things to be studied by the committee. The first area to be studied is North Dakota Century Code provisions requiring bonds. The table fulfills that area of study.

The second area of study is whether the state bonding fund is an appropriate entity to provide those bonds. This is a policy consideration for the committee to determine after receiving relevant testimony. Testimony from the Insurance Commissioner, private bonding companies, and individuals required to be bonded by law would provide information on which the committee may base its determination.

The third area of study is whether private entities within the state provide bonds for public officials and other individuals and entities required to be bonded. This area of study applies to persons required to be bonded but not bonded by the state bonding fund. The committee may receive testimony from these persons to determine if they are able to obtain bonds within this state. Alternatives to obtaining a bond from private companies include the state bonding fund or separate bonding funds for each endeavor, like the cash bond fund for plugging or reclaiming oil and gas wells under NDCC Section 38-08-04.11 or the surface coal mining and reclamation fund under Section 38-14.3-03. Another example, under Section 43-09-14, allows master and Class B electricians to pay \$50 or \$40 respectively, instead of a surety bond, for deposit in a special fund. The special fund is used for completion of installations abandoned by electricians.

The fourth area of study is to determine whether the bonds required by statute are appropriate and necessary. This is a policy determination for the committee. The committee may base its determination on a comparison among the bonds in the table along

with a consideration of the advantages of a bond and the chance for damage to be incurred on which the bond may be liable. The committee may receive testimony on the number of times and the amount when there have been claims on bonds by the Insurance Commissioner and from major bonding companies within this state. In

addition, the committee may compare the persons bonded in the table to those not bonded, but similarly situated.

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