

### D. GLOSSARY of INSURANCE TERMS

**Accident** - An unforeseen, unintended, and unexpected event, which occurs suddenly and at a definite place. See **Occurrence**.

**Act of God** - An accident or event that is the result of natural causes, without human intervention, that could not have been prevented by reasonable foresight or care.

**Actual cash value (ACV)** - A method for placing value on property as of the time of its loss or damage. ACV may be determined as replacement cost, less depreciation. The market value of an item may be used to help determine actual cash value. Contrast with **replacement cost**.

**Additional Insured** - A party other than a named insured who is protected under the terms of an insurance policy without the obligation to pay premium. Usually, additional insureds are added by endorsement. See **Named Insured**.

**Admitted Company** - An insurance company licensed by the Insurance Division of the State of Nevada.

**Advertising Liability** - This refers to acts committed or alleged to have been committed in any advertisement, publicity article, broadcast, or telecast, or arising out of the named insured's advertising activities. Coverage includes: libel, slander, or defamation, infringement of copyright or slogan, piracy unfair competition, or idea misappropriation under an implied contract, invasion of right or privacy.

**Agent (Insurance)** - A representative of one or more insurance companies who, operating under the authority of an agency contract, solicits, negotiates, and effectuates contracts of insurance.

**Aggregate limit** - The total amount payable under an insurance policy, regardless of the number of claims. This is usually based on an annual total amount paid.

**Aircraft coverages** – Policies designed to cover risk associated with the operation and ownership of aircraft. As with any specialty line of insurance, the absence of standardized forms limits practice to specialty markets.

**Aircraft hull and liability insurance** is the counterpart of personal or commercial auto policies coverage.

**Aircraft products insurance** is the counterpart of products liability coverage.

**Air cargo** insurance is mirrored in motor truck cargo.

**Hangarkeepers liability** is akin to garagekeepers coverage.

**All Risk Coverage** - Insurance that protects against all risk of loss except those specifically excluded. In an all-risk policy the burden of proof that the peril causing the loss was excluded falls to the insurer. In a named peril policy the burden of proof that damage was caused by an insured peril falls to the insured.

#### **Automobile Liability Insurance**

**Any Auto** - incorporates all of the insurance coverage parts below.

**All Owned Autos** - coverage on a blanket basis for all Contractor-owned vehicles.

**Scheduled Autos** - coverage for only those Contractor-owned vehicles named in the insurance policy.

**Hired Autos** - coverage for borrowed, hired, rented or short-term lease vehicles. (Long-term leased vehicles are usually covered as owned vehicles).

**Non-Owned Autos** - required of Contractors who does not have "Any Auto" insurance and whose employees use personal vehicles on company business.

**Auto physical damage insurance** - Insurance on the vehicle, itself. This usually is broken down into collision and other than collision coverages.

**Bailee** - One who has is charged with the care of the property of another. For example, a garage is bailee of a customer's ("bailor's") car (the "bailment") and a jeweler is a bailee of customers' jewelry while in for repair or appraisal.

**BI** - A shorthand expression for "bodily injury."

**Bid bond** - Guarantees an owner, the "obligee," that the accepted contractor will actually undertake the work and that the contractor will furnish performance, payment, and, perhaps, maintenance bonds — or that the contractor will pay the owner the difference between the amount of the contractor's accepted bid and the bid of another contractor who has to be called in to complete the project.

**Binder** - A temporary insurance agreement that obligates the several parties of the contract if the loss insured against occurs before the policy is issued; a legal document pending issuance of the policy contract.

**Blanket Insurance** - A single amount of insurance covering several items, as opposed to "specific insurance", which covers one specific property, or a particular interest in a property.

**Bodily injury/harm** - A term that refers to physical injury, sickness, or disease, or death resulting there from.

**Bond** - A contract for expressing surety. A bond engages three entities; the "surety" (bonding company) sells the bond to the "principal" for the purpose of paying the amount the principal will owe to the "obligee" upon failure of the "principal" to perform some act or provide some service under agreed terms.

**BOP** – A shorthand expression for **Business Owners' Policy**.

**Broker** - The representative of the buyer of liability and other insurance who deals with agents or companies in arranging for the coverage required by the customer.

**Builder's Risk Insurance** - Insurance coverage to protect a building in the course of construction.

**Business Owners policy (BOP)** - A package of property and liability insurance for small and medium size businesses, the BOP owes its origin to the success of the homeowners policy.

**Carrier** - An insurance company which "carries" the insurance.

**Captive insurer** - An enterprise with all the authority to perform as an insurance company, but is organized by a parent company for the express purpose of providing the parent company's insurance.

**Care, custody, or control** - An expression common to liability insurance contracts. It refers to an exclusion in the policy eliminating coverage for damage to property of others that is in the insured's "care, custody, or control." The insured has a bailee relationship to the property, in other words, making the insured liable for the care of the property beyond damage caused by negligence. A bailees' floater is often used to cover the insured's obligation for the care of such property.

**Casualty insurance** - The type of insurance concerned with legal liability for losses caused by bodily injury to others or physical damage to property of others.

**Certificate of insurance** - A written description of insurance in effect as of the date and time of the certificate. The certificate does not ordinarily confer any rights on the holder, i.e., the issuing insurer does not promise to inform the holder of change in or cancellation of coverage. An "information only" document.

**Claim** - The amount of damages for which an insured seeks reimbursement. Once the amount has been determined, it becomes a loss. Claim and loss are often used interchangeably.

**Claims-made Policy** - Liability insurance that applies only to a claim which is made during the policy period or during a designated **extended reporting period** beyond expiration. Any form of insurance under which the trigger of coverage is the presentation of a claim against the insured rather than the date on which the loss occurred. Opposed to "**occurrence**" policy.

**Collision insurance** - A type of physical damage insurance available for automobiles. Coverage is triggered when damage is caused by striking against another object.

**Combined Single Limit (CSL)** - Single limit of liability coverage for both bodily injury and/or property damage, contrasted with split limits, where specific limits apply to bodily injury and property damage separately.

**Commercial Bonds** - A general classification of bonds that refers to all bonds other than contract and performance bonds. Commercial bonds cover obligations typically required by law or regulation. Each bond is unique to the circumstances at hand.

**Commercial General Liability (CGL) Insurance** - A broad form of liability insurance usually covering business organizations to protect them against liability claims for bodily injury and property damage arising out of their operations. CGL policies typically exclude liabilities arising out of professional services and some other risks such as the use of automobiles.

**Common Law** - The body of law derived from judicial decisions and opinions, rather than from statutes or constitutions.

**Completed Operations** - Liability a contractor might incur after the job is completed from improperly performed work.

**Contingent Liability** - Liability incurred because of negligence of a person engaged by the insured to perform work, for example, a contractor's responsibility for work of a subcontractor.

**Contract** - An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law.

**Contract Bonds** - A general classification of bonds that provide financial security and the construction assurance on building and construction projects by assuring the project owner (obligee) that the contractor (principal) will perform the work and pay certain subcontractors, laborers, and material suppliers. In many cases, two bonds are issued: a “performance bond” to cover performance and a “payment bond” to cover labor and materials.

**Contractual liability** - Liability that arises by assumption under contract. For example, in certain leases, a tenant may assume a landlord's liability to others for unsafe conditions on the premises.

**Court/Probate Bonds – see judicial bonds.**

**Crime insurance** - A broad category of contracts covering losses of property through criminal activity — from employee dishonesty to burglary and robbery, computer fraud, and forgery. When issued by insurance companies that are referred to as **Commercial Crime Insurance**. Sureties provide similar coverage, also known as **Fidelity Bonds**. Both types of contracts are designed to reimburse the named employer for loss sustained by reason of any dishonest acts of their covered employees.

**Cross Liability** - Liability between two different insureds of a single liability insurance policy. A “cross liability”, or “severability of interests”, clause says that each insured will be treated as though the policy applied separately to each. The standard Commercial General Liability policy titles this condition a “Separation of Interests”.

**Damages** - Monetary compensation for loss or injury to person or property.

**Declarations page** - section of the insurance policy that discloses information pertinent to the coverage promised including names, addresses, limits, locations, term, premium, forms, etc.

**Deductible** - A provision requiring the insured to pay a specified portion of the loss on each claim.

**Direct Writers** - Insurers who sell policies through salaried employees or exclusive agents rather than through independent agents or brokers.

**Discovery Period** - Time given the insured after expiration of a policy to discover and make claim for a loss that occurred during the policy term.

**Duty to defend** - Part of the insuring agreement of many policies. The insurer has the duty to defend the insured in event of a covered loss.

**E & O** - Errors and omissions, or professional liability. Professionals, public officials, directors, and officers all make decisions, on which others rely, becoming susceptible to lawsuits for errors or omissions. See **malpractice**.

**Employers Liability** - Legal liability imposed on an employer making him responsible to pay damaged to an employee injured by the employer's negligence.

**Endorsement** - A provision added to an insurance policy to modify it. An endorsement supersedes the printed policy text. If two endorsements contradict each other, the one with the latest date prevails.

**Exclusion** - Coverage that is specifically eliminated from an insurance policy.

**Excess insurance** - Coverage that applies on top of underlying insurance that is primary, i.e., that pays until its coverage limit is exhausted at which point the excess coverage takes over. There may or may not be underlying insurance for losses less than this amount

**Exposure** - An estimate of the probability and potential severity of loss from some hazard, contingency, or circumstance. Often used as a synonym for risk.

**Extended Reporting Period** - The time period beyond the expiration of the original policy term during which an insured may report claims from acts that occur within the original policy term and obtain coverage for such claims.

**Fidelity Bond** - See Crime Insurance.

**Fiduciary** - One who is appointed to act in the best interests of another. A fiduciary is a person appointed by the court to handle the affairs of persons who are not able to do so themselves. Fiduciaries are often requested to furnish a bond to protect against a lack of faithful performance of their duties.

**Fiduciary Bonds** - Bonds which protect against dishonest accountings and a lack of faithful performance of duties by administrators, trustees, guardians, executors, and other fiduciaries. Fiduciary bonds, in some cases referred to as probate bonds, are required by statutes, courts, or legal documents for the protection of those on whose behalf a fiduciary acts. They are needed under a variety of circumstances, including the administration of an estate and the management of affairs of a trust or a ward. Also see **judicial bonds**.

**Fiduciary liability insurance** - This insurance covers claims arising from: (1) a breach of the responsibilities or duties imposed on a benefit plan administrator; or (2) a negligent act, error, or omission of the administrator.

**Financial Responsibility Law** - A law requiring persons involved in auto accidents to provide a certain minimum amount of money, usually satisfied by insurance policies. All states have such a law.

**Fire legal liability** - Public liability policies routinely exclude coverage for damage to property in an insured's care, custody, or control. This leaves a big gap in a tenant's coverage, a gap partially filled by an exception in the commercial general liability policy that restores limited coverage for fire damage to the landlord's building. Perhaps the best benefit of the exception is to call attention to the exposure so arrangements can be made for broader coverage at appropriate limits.

**Floater** - A policy covering property which may not have a fixed location.

**Force Majeure** - A clause in contracts excusing the contractor from performance if he is restrained by acts beyond his control.

**Hazard** - A condition that creates or increases the probability of a loss. It differs from "peril", which is a cause of loss.

**Hold harmless agreement** - A contractual assumption by one party of the liability exposure of another. Lease agreements, for example, commonly require the tenant to hold the landlord

harmless for bodily injury or property damage experienced by others on the premises. **Hold harmless** by itself does not imply indemnification. **Indemnification** includes assuming the financial responsibility for all claims brought against the protected party within the scope of the agreement. **Hold harmless agreements** only prevent the agreeing party from bringing action against the protected party; it doesn't protect from the actions of other parties.

**Implied Warranty** - A warranty arising by operation of law because of the circumstances of a sale, rather than by the seller's express promise.

**Improvements and Betterments** - Improvements paid for by the tenant which adds value to leased premises.

**Indemnify** – A duty to make good any loss, damage, or liability another has incurred. To indemnify is a fundamental concept governing insurance. With an indemnification policy, no claim need be paid until the insured has actually suffered a loss. In a property and casualty contract, the objective is to restore an insured to the same financial position after the loss that he or she was in prior to the loss. The insured should not be able to profit by damage or destruction of property, nor should the insured be in a worse financial position after a loss.

**Indemnity Contract** - Arises when one individual takes on the contractual obligation to pay for any loss or damage that has been or might be incurred by another individual. The *right to indemnity* and the *duty to indemnify* ordinarily stem from a contractual agreement, which generally protects against liability, loss, or damage.

**Indemnification Agreement** - A contract provision whereby one party assumes certain legal liabilities on behalf of another party. Such a contract provision could be of **limited** form, where a party reaffirms responsibility for its own negligent acts thus protecting another party from vicarious liability; an **intermediate** form, where a party reaffirms its responsibility and agrees to share responsibility for joint and concurrent negligence of both parties; or a **broad** form, where a party assumes responsibility for all liability including that arising out of the sole negligence of the other party.

**Insurable Interest** – The financial or legal interest that an insured must have in the person, object or activity covered by an insurance policy. No insurance policy should be issued to insure anyone who will not actually be out-of-pocket if the calamity which is insured against should happen; an essential element of an insurance contract. If the policy does not have an insurable interest as its basis, it will usually be considered a form of wagering and therefore held to be unenforceable.

**Insurance** - A legal contract whereby the insurer, for a consideration (the premium) agrees to indemnify the insured for loss from specified perils and under certain conditions. A mechanism by which the risk of financial loss is transferred from an individual, company, organization, or other entity to an insurance company.

**Insurance Services Office (ISO)** - An organization providing statistical information, actuarial analyses, policy language, and related services for the insurance industry.

**Insured** - The person who has purchased an insurance policy and is protected by it; sometimes also referred to as the assured.

**Insurer** – An Insurance Company.

**Joint and several liability** - A legal doctrine under which a creditor or claimant may demand payment or sue one or more of the parties separately or all of them together.

**Judicial bonds** - Two types of bonds available to guarantee faithful performance of court appointed duties. Fiduciary bonds guarantee the faithful performance of persons entrusted by the courts in the management, conservation, and disposition of property. Litigation bonds (or "court bonds") are required in court actions. Bail bonds and appeals bonds are litigation bonds; where the bond amount is forfeited if the bonded person disappears or the appeal is lost.

**Lapse** - Termination of a policy because of failure to pay the premium.

**Law of large numbers** - An underlying principle of insurance; the larger the number of participants in a given arrangement, the more accurate the rate is to the exposure.

**Liability** - A legally enforceable obligation or responsibility, in the insurance context liability is usually pecuniary.

**Liability Insurance** (general liability insurance) - Refers to the form of coverage whereby the insured is protected against injury or damage claims from other parties. Any form of coverage whereby the insured is protected against claims of other parties from specified clauses.

**Libel** - A written defamatory statement about another.

**License and Permit Bonds** - Bonds required as part of the licensing or permitting within many cities, counties, states or other political subdivisions. They may be required for a number of reasons, including the payment of certain taxes and fees or providing consumer protection as a condition to granting licenses related to selling things such as motor vehicles or contracting services.

**LIMIT**— The maximum amount for which an insurer may be liable for any loss, as set forth in an insurance policy.

**Aggregate Limit**— The maximum amount of coverage that an Insurer will pay for all losses during a specific period of time, usually the contract period, no matter how many separate accidents may occur.

**Annual Aggregate Limit**— The maximum amount payable under an insurance policy for all losses occurring within a particular calendar or fiscal year.

**Per Accident Limit**— The maximum amount the insurer will pay for claims growing out of a particular accident, regardless of the number of persons injured or property interests damaged.

**Per Person Limit**— The maximum amount the insurer will pay for bodily injury to any one person in any one accident.

**Single Limit**— The overall maximum on the insurer's liability for all types of bodily injury, property damage or personal injury claims growing out of one accident, regardless of the number of persons suffering injury.

**Split Limit**— Separate limits of liability for bodily injury and property damage claims. Many split-limit liability policies contain three separate limits for (1) bodily injury to each insured person, (2) bodily injury to two or more persons injured in the same accident, and (3) property damage per accident.

**Long tail** - Refers to liability under policies written on an occurrence basis. Claims stemming from injury or damage occurring years earlier can be presented for coverage long after the policy has expired. Contrast with Claims-made.

**Loss Payable Clause** - A policy clause providing for payment to a third party at interest, such as a mortgage holder or lien holder, as its interests appear. See **Loss Payee**.

**Loss Payee** - The party named in a loss payable clause, to which insurance proceeds are to be paid in the event of damage to property in which the loss payee has an insurable interest.

**Malpractice** - Improper professional actions or failure to exercise proper professional skills by a person practicing a profession, such as a physician, lawyer, architect, accountant, etc. that result in harm to the client or patient. Professional liability is a somewhat broad term, which includes both bodily injury and financial injury. See **Errors and Omissions**, (E&O).

**Maintenance bond** - Guarantees that faulty work or defective materials charged to the bond principals will be corrected or replaced. A maintenance bond may be included among the terms of a performance bond

**Named Insured** - The one named in the insurance policy. It could be any person, firm, or corporation or any of its members specifically designated as insureds in the policy. A named insured under the policy has rights and responsibilities not attributed to additional insureds. See **"Additional Insured"**

**Negligence** – The failure to exercise the standard of care that a "reasonable person" would have exercised in the same situation. This can include an act or a failure to act. Negligence is also a tort (a civil wrong for which a legal remedy may be obtained) grounded in such a failure which is usually expressed in terms of the following elements: duty, breach of duty, a direct causal link between the breach and the harm, and damages or harm.

**Non-admitted Company** - See "Admitted Company".

**Non-owned Auto** - This term signifies an auto that is not owned, hired, nor borrowed by the insured under a commercial auto policy. Employees' cars used in company business are commonly classified this way. The employer's auto liability cover for use of non-owned autos is covered by entry of symbol 1 ("any auto") or symbol 9 ("non-owned autos") on the declarations page.

**Obligee** - A term used in surety bonds to refer to the individual or firm that is to benefit from the bond's protection. A performance bond, for example, provides the obligee property owner with recourse if the bonded contractor, the principal, fails to perform.

**Obligor** - A term used in surety bonds to refer to the individual or firm bound by an obligation. Also known as the "principal".

**Occurrence** - in insurance contract language, continued or repeated exposure to conditions which unexpectedly results in injury during the period an insurance policy is in effect; in contrast to sudden injury or damage from an accident which takes place at a specific time and location. A basis for coverage in general and auto liability policies.

**Occurrence Form** - An insurance policy whereby coverage is provided for losses stemming from an event when the insurance policy was in force even if the claim is not made for several years. There is no cut-off date after which a claim will not be honored, except for the workings of a statute of limitations that may apply in a particular jurisdiction.



**Owners and Contractors Protective Liability Insurance (OCP)** - Insures the legal liability of contractors and other persons for the negligent acts of subcontractors and may include their own negligent supervision of the work performed. The State would be the named insured.

**Other Insurance Clause** - A clause found in almost every policy stating how it will respond when other insurance policies also cover a claim.

**Paid losses** - The losses that have been paid for a claim.

**Performance bond** - A bond that guarantees the property owner (the "obligee") that the contractor with the winning bid on a job will perform as promised and on time.

**Payment bond** - Sometimes also called a "labor and materials bond," this bond guarantees that bills owed by the contractor will be paid as they come due. The agreement may be incorporated into the performance bond.

**PD** - A shorthand expression for "property damage."

**Peril** - A cause of loss, such as fire, earthquake, and flood.

**Personal injury** - Distinguished from "bodily injury," this term relates to any harm including bodily injury or harm, any invasion of personal rights, and in the worker's compensation context any harm, including a worsened preexisting condition, that arises in the scope of employment.

**Premises and operations liability** - Once known as owners, landlords, and tenants legal liability, or as manufacturers and contractors liability, depending on the business's activity, the term refers to the liability exposure of business entities to third parties (customers, guests, and passers by) who may become injured or have property damaged through the negligent acts of the business persons, their agents, or employees. Coverage of this exposure is by way of the commercial general liability policy. Contrast with Products and completed operations liability.

**Primary Insurance** - The first policy applicable to a claim; as opposed to excess insurance, which applies once the primary limits are exhausted.

**Principal** - In suretyship, the party whose actions, honesty, or responsibility are being guaranteed.

**Products and completed operations liability** - The liability exposure of the manufacturer whose malfunctioning products may cause injury or property damage or of the contractor whose failed structures or projects may do the same. Coverage of the exposure is a feature of the commercial general liability policy. The insurance does not in any way constitute a guarantee of either the insured's product or work. Contrast with **Premises and operations liability**

**Professional Liability** - See E & O

**Property Damage Liability Insurance** - Covers the insured's legal liability for negligent damage to property of others.

**Real property** - Land and anything growing on, attached to, or erected on it, such as buildings, and other structures (such as a swimming pool or tool shed).

**Renewal** - The extension of the term of coverage of an expired policy, commonly by replacement with another policy effective on the date of expiration of the previous policy.

**Replacement cost insurance** - Covers property — both building and contents — on the basis of full replacement cost without deduction for depreciation on any loss sustained, subject to the terms of the co-insurance clause. See Actual cash value.

**Retention** - That portion of loss an insured undertakes to handle on his or her own. Same as a deductible except a policy with a deductible usually pays the entire loss then collects the deductible from the insured. A deductible is a form of **self-insured retention**

**Retro Date** - This term refers to the inception date of the first policy written on a claims made basis. The date is designated on each succeeding claims-made policy, thereby affording coverage for any occurrences that may have taken place since the retroactive date, provides that they are reported between the inception and expiration of the current claims-made policy.

**Rider** - Endorsement.

**Risk** - The chance of loss. The magnitude of risk is a function of the probability of an unfavorable outcome and the severity of the consequences of that outcome.

**Risk Management** - The process of minimizing the probability and severity of an unfavorable outcome at the lowest long-term cost to the organization.

**Schedule** - A list of items insured. **Schedule** - List of items on a policy declaration, sometimes also showing descriptions and values.

**Self-Insurance** - The systematic provision of a fund to provide for the loss which the individual or firm may have. A term used when it has been decided to assume one's own risk through internal financing mechanisms rather than to purchase insurance.

**Self-Insured Retention (SIR)** - See "Retention".

**Severability of Interests** - See "Cross liability".

**Statutory Law** - Written law created by the legislature, as opposed to common law which is derived from custom and judicial opinions.

**Solvency** - Insurers must have sufficient assets (capital, surplus, reserves) in order to satisfy statutory financial requirements (investments, annual reports, examinations) and to meet liabilities

**Strict liability** - Liability that does not depend on actual negligence or intent to harm, but is ascribed to a manufacturer or seller as an absolute duty to make something safe. Strict liability most often applies to ultra hazardous activities or products.

**Subrogation** - The right of one party who has paid for the loss of a second party to obtain recompense from the third party who is responsible for the loss. For example, an insurance company becomes "subrogated" to the rights of its insured to the extent of the insurer's payment for collision damage caused by the negligence of the other driver.

**Surety Bond** – See bond.

**Surety Company** – A company licensed by the state insurance department to write bonds (surety and fidelity). Most bond companies are divisions of a large property/casualty insurance company.

**Surety Association of America (SAA)** - A voluntary, non-profit, unincorporated association that is licensed as a rating or advisory organization for surety and fidelity insurance in all states, D.C., and Puerto Rico. The SAA handles statistical information, filings, publications, and surety and fidelity bonds

**Term** - The length of time for which an insurance policy or surety bond is written and in effect.

**Third party** - Someone other than the insured or insurer who may become a claimant under a form of public liability coverage because of injury or property damage alleged to have been caused by the negligence of the insured.

**Tort** - A wrongful act or omission, other than a crime or breach of contract, for which the remedy is usually monetary damages. Many tort claims arise from **negligence**.

**Third party administrator (TPA)** - A TPA is a contractor that adjusts and administers insurance claims.

**Tail coverage** - Coverage for claims made after a claims-made liability policy has terminated; the extended reporting or discovery period.

**Umbrella Insurance** - A broad, high-limit policy, usually requiring the insured to carry primary or underlying insurance. An umbrella policy generally differs from an excess policy in that the umbrella can provide some coverage not available from underlying policies - subject to a significant self-insured retention.

**Underground Storage Tank (UST)** - Tanks sunk in the ground that are used to store or dispose of gasoline or other fuels, hazardous chemicals, or other pollutants or contaminants.

**Underinsured motorists' coverage** - Coverage for the insured and passengers whenever the at-fault driver in an accident has auto liability insurance with lesser limits than the insured's. This coverage lies atop "uninsured motorists' coverage" or atop the at-fault driver's low limit automobile liability insurance and provides the insured and passengers with protection equal (usually) to the insured's own automobile liability cover.

**Underlying insurance policy** - The policy providing initial coverage for a claim until its limit of liability is reached and an umbrella or excess policy's coverage is triggered.

**Underlying limits** - The limits of liability of the policies underlying an umbrella or excess policy.

**Underwriter** - One who researches and then accepts, rejects, or limits prospective risks for an insurance company.

**Valuable papers coverage** - Provides "all risk" coverage on "valuable papers," such as: written, printed, or otherwise inscribed documents and records, including books, maps, films, drawings, abstracts, deeds, mortgages, and manuscripts. It covers the cost of research to reconstruct damaged records, as well as the cost of new paper and transcription.

**Waiver** - Surrender of a known right; for example, waiver of subrogation under a fire insurance policy.

**Waiver of subrogation** - A waiver by the named insured giving up any right of recovery against another party. Normally, an insurer has the right of subrogation and insurance policy requires that subrogation (recovery) rights be preserved. In some insurance policy, a written waiver of rights is permitted if it is executed before the loss occurs.

**Wear and tear exclusion** - A common heading for an "all risks" exclusion relating to a group of events that do not represent risk at all. Property will become worn out and torn; it will rust, settle, become rotted, infested, marred, scratched, etc. It is easy to distinguish however between the marring that occurs over time (excluded) and marring that occurs when a concrete block is dropped onto a fine wooden table.

**Warranty** – In the insurance context, a pledge or statement by the insured that the facts relating to the person or thing insured, or the risk insured are as stated.. A breach of warranty usually voids the policy.

**Workers Compensation Insurance** - An insurance system in which liability is imposed by statute on an employer, whether or not the employer has been negligent, who must provide benefits prescribed by law to employees or their dependents as a result of job-related injuries or death.



# ACORD

## Certificates

*It's important to note that what's said in this FAQ is not intended to serve as legal advice and is only a general statement not directed to any particular set of facts.*

## FAQs

### WHAT IS A CERTIFICATE OF INSURANCE?

A certificate of insurance is a document that provides information about insurance policies. Millions of insurance certificates are issued every year, primarily in the United States. The majority of certificates are issued upon policy renewal to provide this information to third parties. These third parties are known as certificate requestors/holders. Generally speaking, certificates list one or more lines of insurance, the limits associated with those coverages, and the insurer providing coverage.

### WHAT CERTIFICATES OF INSURANCE DOES ACORD PUBLISH?

ACORD publishes the following certificate of insurance forms:

- ACORD 20 - Certificate of Aviation Liability Insurance
- ACORD 21 - Certificate of Aircraft Insurance
- ACORD 22 - Intermodal Interchange Certificate of Insurance
- ACORD 23 - Automobile Certificate of Insurance
- ACORD 24 - Certificate of Property Insurance
- ACORD 25 - Certificate of Liability Insurance
- ACORD 27 - Evidence of Property Insurance
- ACORD 28 - Evidence of Commercial Property Insurance

### WHY DO BROKERS AND AGENTS ISSUE CERTIFICATES OF INSURANCE?

Policyholders may request a certificate of insurance for many reasons. Some of the more common are:

- They are a tenant, and a building owner is requesting information about the existence of liability insurance coverage
- They are the mortgagor of a building, and are requesting information about the existence of property insurance coverage upon closing or renewal
- They leased equipment and the owner of equipment wants information about the existence of property insurance coverage while equipment is in possession of the client
- They need evidence of workers compensation insurance in order to obtain a contract.

### WHAT'S THE DIFFERENCE BETWEEN A CERTIFICATE AND A POLICY?

A Certificate of Insurance is NOT an insurance policy, and does not serve to provide, endorse, amend, extend or alter in any way the terms of an insurance policy. Only an endorsement, rider or amendment to the policy can effect changes in coverage. Reference to a contract between the client and a third party on a certificate does not provide coverage.

### WHY ARE THERE SEPARATE CERTIFICATES FOR PROPERTY INSURANCE AND LIABILITY INSURANCE?

Typically, a property insurance policy obligates the insurer to notify the mortgage holder in the event of policy cancellation. A typical liability insurance policy obligates an insurer to notify only the first named insured and no one else of policy cancellation, unless the policy is endorsed to provide notice to another party. For this reason, ACORD working groups recommended publishing separate certificates.

### I'M AN INSURANCE PRODUCER, AND A CLIENT HAS ASKED ME TO USE AN OLDER VERSION OF AN ACORD CERTIFICATE—WHAT SHOULD I DO?

As is true for all ACORD forms, we monitor and revise our forms as regulatory requirements change, and, where necessary, file them with state insurance departments as required. Any earlier editions of our forms that have been withdrawn from the forms library are not kept up-to-date as to regulatory requirements, and therefore should not be distributed for use. You should tell your client that a non-current version of an ACORD form may not be compliant with insurance regulations and that its use would be risky. It is imperative that all ACORD forms users use the most current versions of our forms. You can determine which of ACORD's forms are current by referring to our website ([www.acord.org](http://www.acord.org)).

### MY AGENCY MANAGEMENT SYSTEM STILL PROVIDES AN OLDER CERTIFICATE, AND A CLIENT HAS ASKED ME TO ISSUE ONE. WHAT SHOULD I DO?

You should ask your agency management system vendor if a software update containing current ACORD forms is available and how you can obtain that update. Vendors have certain software-updating obligations in response to forms revisions.

To use ACORD forms you have to be licensed by ACORD. Generally speaking, under ACORD's present licensing regime, agents and brokers can be licensed in two ways. One way is to buy ACORD forms-producing software from an ACORD-licensed vendor. In that case, the purchaser becomes authorized to use ACORD forms via that software. If an agent or broker wants to use an ACORD form other than through an ACORD-licensed vendor, it is easy to become licensed through ACORD's Advantage program. (The program is detailed at <http://www.acord.org/standards/forms/advantage/Pages/default.aspx>).

Regardless of where users lawfully obtain ACORD forms, it is strongly suggested that they regularly go to ACORD's website ([www.acord.org](http://www.acord.org)) to obtain information on the currency of the forms being utilized and, if necessary, follow the instructions to download the current versions.

Once a form is outdated, ACORD no longer checks on whether it remains regulatorily compliant. Thus, anyone using an outdated form does so at great risk.

You should consult with your legal adviser on how ACORD's licensing requirements apply to your situation and how you may be affected in the future by any changes ACORD may make to its present licensing structure.

#### WHY DID THE CERTIFICATE CHANGES HAPPEN IN LATE 2009/EARLY 2010?

Some of the changes involved formatting enhancements proposed by an ACORD working group, and voted on by our membership. Other changes were made as a result of changes in state insurance department regulatory requirements. As ACORD often does for the sake of efficiency in our forms production process, in order to minimize the number of times we revise any specific form, we combined these two sets of changes and updated the certificates to reflect all necessary revisions.

#### WHAT WERE THE RECENT FORMATTING AND REGULATORY CHANGES THAT LED TO NEW RELEASES OF ALL THE CERTIFICATES IN LATE 2009/EARLY 2010?

The updates associated with the regulatory requirements involved two areas on these forms:

- The disclaimer text found near the top of the certificates (immediately below the form title)
- The cancellation text found near the bottom of the certificates

This document focuses on the cancellation text revisions. For reference, here is a comparison of the old text and the new text:


ACORD's Certificates Forms Working Group had been in the process of reviewing various certificates for possible enhancements. During the summer of 2009, working group participants made the following recommendations concerning the old cancellation text:

- The fill-in field for a number of days should be removed. The amount of advance notice required under an insurance policy may vary based upon a carrier's own practices. Some insurance policies include cancellation provisions with allowances for more than one count of days, dependent on the reason for cancellation. For example, many policies may be cancelled with 10 days notice for non-payment, and 30 days notice for other reasons. Therefore, one fill-in field on the certificates for the number of days is inadequate. The precise advance notice at cancellation may vary based on policy language as well as regulatory requirements.
- The word "endeavor" should be removed. Policy cancellation provisions generally don't use the phrase "endeavor to". Only a policy can obligate an insurer to provide notice of cancellation. Unless a policy's provisions explicitly provide for notice to a party also listed as the certificate holder on the certificate of insurance, the insurer is not obliged to notify that party.

At about the same time the Certificates Working Group was considering the cancellation text, the South Dakota Insurance Department issued several Certificates of Insurance Bulletins (2009). As a result, ACORD had to make specific changes to its Certificate Disclaimer Statement(s) (which state in part "This certificate is issued as a matter of information only...") and to its Cancellation Provision(s). ACORD presented the draft cancellation text developed by the working group to the South Dakota regulators and confirmed that the text satisfied its regulatory requirements.

Certificates of insurance may be viewed as a summarized reflection of an insurance policy and are only informational. The policy is the definitive source for its provisions, not the certificate. If any party in addition to the first named insured desires a copy of a cancellation notice in the event the policy is cancelled, that party should be expressly endorsed onto the policy as a cancellation notice recipient.

A Certificate of Insurance/Evidence of Insurance Additional Remarks Section, as well as the ACORD 101 Additional Remarks Forms may also be used to include more information about the policy, e.g. Number of Days of Written Notice.

#### WHAT IS THE STATUS OF CERTIFICATE UPDATES?

ACORD published new releases of all of its certificate forms in late 2009/early 2010. New versions of the ACORD 24 and ACORD 25 were published in October 2009 and the others were published January 2010. ACORD plans to release new editions of the ACORD 23 & 25 later in 2010 to address non-regulatory formatting changes approved by membership vote in November, 2009. The next release of the ACORD 23 will be expanded in scope to include leased equipment.

#### WHY ARE THE ACORD 27 & 28 TITLED "EVIDENCE" FORMS?

The ACORD 27 and 28 forms are certificates of insurance designed for delivery to parties that have a financial interest in the property covered by the policy listed on each. These parties are typically lending institutions and the lending community prefers the title "Evidence of..." as contrasted with "Certificate of...". Regardless of the "Evidence" reference in the title, these forms are certificates of insurance, and as stated in the forms, and as required by regulation, are issued as a matter of information only.

#### WHAT IS THE CURRENT AND FUTURE STATUS OF THE ACORD 27 AND 28?

ACORD's Certificates Working Group identified consideration of potential revisions to the ACORD 27 and 28 forms as a priority in 2008. Throughout 2008 and 2009, much time and effort was spent attempting to resolve differences of opinions concerning these forms, as well as related formatting enhancements. Active participants in the group represented lenders, producers, and insurers. In brief, despite extensive efforts, the participants were unable to come to consensus. The current forms reflect the result of required regulatory changes, and formatting changes developed by ACORD members in an ACORD working group, and voted on in our regular maintenance request process.

**NRS 616A.310 “Sole proprietor” defined.** “Sole proprietor” means a self-employed owner of an **unincorporated business** and includes working partners and members of working associations. Coverage remains in effect only if the sole proprietor remains a domiciliary of Nevada.

(Added to NRS by 1975, 1017; A 1987, 598)—(Substituted in revision for NRS 616.114)

**NRS 616B.627 Contractor with State or political subdivision: Submission of certificate of compliance; coverage pursuant to contract; sole proprietor who does not use employees.**

1. Except as otherwise provided in this section, before any **person, firm or corporation commences work under any contract with the State** or any political subdivision thereof, or a metropolitan police department, **the contractor shall furnish to the state agency,** political subdivision or metropolitan police department having charge of the letting of the contract **a certificate of the insurer certifying** that the contractor has complied with the provisions of [chapters 616A to 616D](#), inclusive, of NRS. A state agency, political subdivision or metropolitan police department may furnish coverage for industrial insurance for a contractor as specified in the contract.

2. In lieu of furnishing a certificate of an insurer pursuant to the provisions of subsection 1, a sole proprietor who does not use the services of his employees, if any, in the performance of a contract with the State or any political subdivision thereof, or a metropolitan police department, may submit to a state agency, political subdivision or metropolitan police department specified in subsection 1 an affidavit indicating that the sole proprietor:

(a) In accordance with the provisions of [NRS 616B.659](#), has not elected to be included within the terms, conditions and provisions of [chapters 616A to 616D](#), inclusive, of NRS; and

(b) Is otherwise in compliance with those terms, conditions and provisions.

3. If a sole proprietor submits an affidavit specified in subsection 2 to a state agency, political subdivision or metropolitan police department specified in subsection 1, the state agency, political subdivision or metropolitan police department shall not require the sole proprietor to obtain industrial insurance for himself during any period in which he performs work under the contract for which he submitted the affidavit.

4. A state agency, political subdivision or metropolitan police department that lets a contract to a sole proprietor in accordance with this section:

(a) Must not, for any purpose, be considered to be the employer of the sole proprietor or his employees, if any; and

(b) Is not liable as a principal contractor to the sole proprietor or his employees, if any, for any compensation or other damages as a result of an industrial injury or occupational disease incurred in the performance of the contract.

[29:168:1947; 1943 NCL § 2680.29]—(NRS A 1973, 927; 1981, 1465; 1985, 665; 1993, 549; [2001, 609](#))

**NRS 617.210 Contractor with State or political subdivision: Submission of certificate of compliance; coverage pursuant to contract; sole proprietor who does not use employees.**

1. Except as otherwise provided in this section, before any person, firm or corporation commences work under any contract with the State or any political subdivision thereof, or a metropolitan police department, the contractor shall furnish to the state agency, political subdivision or metropolitan police department having charge of the letting of the contract a certificate of the insurer certifying that the contractor has complied with the provisions of this chapter. A state agency, political subdivision or metropolitan police department may furnish coverage under this chapter for a contractor as specified in the contract.

2. In lieu of furnishing a certificate of an insurer pursuant to the provisions of subsection 1, **a sole proprietor who does not use the services of his employees,** if any, in the performance of a contract with the State or any political subdivision thereof, or a metropolitan police department, may submit to a state agency, political subdivision or metropolitan police department an affidavit indicating that the sole proprietor:

(a) In accordance with the provisions of [NRS 617.225](#), has not elected to be included within the terms, conditions and provisions of this chapter; and

(b) Is otherwise in compliance with those terms, conditions and provisions.

3. If a sole proprietor submits an affidavit specified in subsection 2 to a state agency, political subdivision or metropolitan police department specified in subsection 1, the state agency, political

subdivision or metropolitan police department shall not require the sole proprietor to obtain coverage for himself under this chapter during any period in which he performs work under the contract for which he submitted the affidavit.

4. A state agency, political subdivision or metropolitan police department that lets a contract to a sole proprietor pursuant to subsection 1:

(a) Shall be deemed not to be the employer of the sole proprietor or his employees, if any; and

(b) Is not liable as a principal contractor to the sole proprietor or his employees, if any, for any compensation or other damages as a result of an industrial injury or occupational disease incurred in the performance of the contract.

[20:44:1947; 1943 NCL § 2800.20]—(NRS A 1981, 1500; 1985, 665; 1993, 550; [2001, 611](#))



**AFFIDAVIT OF REJECTION OF COVERAGE**

**PURSUANT TO NEVADA REVISED STATUTES 616B.627 and 617.210**

STATE OF NEVADA        )

                                  ) ss.

\_\_\_\_\_ COUNTY        )

I, \_\_\_\_\_, do hereby swear under penalty of perjury that the assertions in this affidavit are true.

1. I make the following assertions in accordance with Nevada Revised Statutes (NRS) 616B.627 and 617.210.
2. I am a sole proprietor who will not use the services of any employees in the performance of this Contract with the State of Nevada.
3. Pursuant to NRS 616B.659(1), I have not elected to be included within the terms, conditions and provisions of chapters 616A to 616D, inclusive, of the NRS, to secure for myself compensation equivalent to that which an employee is entitled for any accidental injury sustained by myself which arises out of and in the course of my self-employment by filing a written notice of election with the Administrator and a private carrier.
4. I am otherwise in compliance with the terms, conditions and provisions of chapters 616A to 616D, inclusive, of the NRS.
5. Pursuant to NRS 617.225(1), I have not elected to be included within the terms, conditions and provisions of chapter 617 of the NRS, to secure for myself compensation equivalent to that to which an employee is entitled for any occupational disease contracted by myself which arises out of and in the course of my self-employment by filing a written notice of election with the Administrator and a private carrier.
6. I am otherwise in compliance with the terms, conditions and provisions of chapter 617 of the NRS.
7. I acknowledge that the State of Nevada will not be considered to be my employer, and that the State of Nevada is not liable as a principal contractor to me for any compensation or other damages as a result of an industrial injury or occupational disease incurred in the performance of this Contract.

8. Further affiant sayeth not.

I, \_\_\_\_\_, do hereby swear under penalty of perjury that the assertions of this affidavit are true.

NAME \_\_\_\_\_

\_\_\_\_\_

SIGNED and SWORN to before me this \_\_\_\_ day of \_\_\_\_\_, \_\_\_\_\_,  
by \_\_\_\_\_.

\_\_\_\_\_  
NOTARY PUBLIC

**State of Nevada**  
**Department of Administration**  
**PERFORMANCE BOND**

KNOW ALL MEN BY THESE PRESENTS,

That we, \_\_\_\_\_ as Principal, and  
\_\_\_\_\_ a corporation

organized and existing under the laws of the State of \_\_\_\_\_, authorized to transact Surety  
business in the State of \_\_\_\_\_ as Surety are held and firmly bound unto the **State of**  
**Nevada**, as Oblige, in the sum of \_\_\_\_\_ DOLLARS

(\$ \_\_\_\_\_ lawful money of the United States of America, to be paid to the State or its certain attorney,  
its successors and assigns; for the payment whereof, well and truly to be made, we hereby bind  
ourselves, our heirs, executors and administrators, successors or assigns, jointly and severally, firmly by these  
presents.

WHEREAS, the above bounden Principal has been awarded and has entered into a contract  
dated \_\_\_\_\_ with said Oblige to do and perform the following work, to wit:

Contract # \_\_\_\_\_

and will more fully appear in the contract, reference to which is hereby made.

NOW, THEREFORE THE CONDITION OF THIS OBLIGATION IS SUCH, That, if the above bounden Principal,  
his or its heirs, executors, administrators, successors and assigns, shall well and truly perform, or cause to be  
performed, each and all of the requirements and obligations of said contract and any alteration or extension  
thereof made, and shall indemnify and save harmless the State of Nevada, its officers, employees, agents and  
immune contractors as therein stipulated, then this bond shall be null and void, otherwise it shall remain in full  
force and effect.

SIGNED, SEALED, DATED: \_\_\_\_\_

\_\_\_\_\_  
(Name of Contractor)

\_\_\_\_\_  
(Name of Surety)

By \_\_\_\_\_

\_\_\_\_\_  
Attorney-in-Fact

\_\_\_\_\_  
Signature of Nevada Resident Agent



### **Surety Information Office (SIO)**

1828 L Street NW, Suite 720  
Washington, DC 20036-5104  
(202) 686-7463  
(202) 686-3656 Fax  
[www.sio.org](http://www.sio.org)  
[sio@sio.org](mailto:sio@sio.org)

*The Surety Information Office (SIO) is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles, and answer questions on contract surety bonds. SIO is supported by The Surety & Fidelity Association of America (SFAA) and the National Association of Surety Bond Producers (NASBP). All materials may be accessed at [www.sio.org](http://www.sio.org).*



### **The Surety & Fidelity Association of America (SFAA)**

1101 Connecticut Avenue NW • Suite 800 • Washington, DC 20036  
(202) 463-0600 • (202) 463-0606 Fax  
[www.surety.org](http://www.surety.org) • [information@surety.org](mailto:information@surety.org)

*The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.*



### **National Association of Surety Bond Producers (NASBP)**

1828 L Street NW • Suite 720 • Washington, DC 20036-5104  
(202) 686-3700 • (202) 686-3656 Fax  
[www.nasbp.org](http://www.nasbp.org) • [info@nasbp.org](mailto:info@nasbp.org)

*The National Association of Surety Bond Producers (NASBP) is the international organization of professional surety bond producers and brokers. NASBP represents more than 5,000 personnel who specialize in surety bonding; provide performance and payment bonds for the construction industry; and issue other types of surety bonds, such as license and permit bonds, for guaranteeing performance. NASBP's mission is to strengthen professionalism, expertise, and innovation in surety and to advocate its use worldwide.*

# Surety Bonds Or Bank Letters Of Credit





## BORROWING CAPACITY

### Surety Bonds

- Performance and payment bonds are usually issued on an unsecured basis and are usually provided on the construction company's financial strength, experience, and corporate and personal indemnity. The issuance of bonds **does not diminish the contractor's borrowing capacity** and may be viewed as a credit enhancement.

### Bank Letters of Credit

- Specific liquid assets are pledged to secure bank LOCs. Bank LOCs diminish the contractor's line of credit and appear on the contractor's financial statement as a contingent liability. The contractor's cash flow in funding initial stages of construction and retention amounts throughout a contract term can be adversely affected.

## DURATION

### Surety Bonds

- Surety bonds remain in force for the duration of the contract plus a maintenance period, subject to the terms and conditions of the bond, the contract documents, and underlying statutes.

### Bank Letters of Credit

- An LOC is usually **date specific**, generally for one year. LOCs may contain "evergreen" clauses for automatic renewal, with related fees.

## HOW TO OBTAIN

### Surety Bonds

- The contractor obtains the bond through a surety bond producer. A list of surety bond producers is available through the National Association of Surety Bond Producers (NASBP) at [www.nasbp.org](http://www.nasbp.org).

### Bank Letters of Credit

- The contractor obtains the LOC through a banking or lending institution.

## COST

### Surety Bonds

- Generally **0.5% to 2% of contract price**. Bond is project specific, covers duration of contract.
- Included in contractor's bid price.

### Bank Letters of Credit

- Cost is generally **1% of the contract amount** covered by LOC (usually 5% – 10%) — e.g. if the LOC covers 10% of contract,  $\text{Cost} = 1\% \times (10\% \times \text{Contract Amount}) \times \text{years of contract}$ .
- Included in contractor's bid.

Construction project owners may use bank letters of credit to provide financial protection in the event of contractor default. However, completion of the construction project is the primary goal, and a letter of credit offers no such assurance. When it comes to limiting exposure to the inherent risks of construction, choosing the best form of risk management can make a big difference.

Bank letters of credit and contract surety bonds provide similar financial protection. However, contract surety bonds have an edge when compared to bank letters of credit and their effect on borrowing capacity, duration, coverage, cost, and claims and contractor prequalification.

## DEFINITIONS

### Surety Bonds

- A three-party agreement among the surety, the *obligee* (the project owner), and the *principal* (the contractor).
- A performance bond **protects the owner from non-performance and financial exposures** should the contractor default.
- A payment bond, aka labor and material bond, **protects certain subcontractors, laborers, and material suppliers against non-payment by the contractor.**

### Bank Letters of Credit

- A bank letter of credit (LOC) is a **cash guarantee to the owner**, who can call on the LOC on demand. The LOC converts to a payment to the owner and an interest-bearing loan for the contractor.
- The **performance of the contract has no bearing on the bank's obligation to pay on the LOC.**

## PREQUALIFICATION

### Surety Bonds

- A surety company and producer assess the contractor's business operations, financial resources, experience, organization, existing workload and its profitability, and management capability to **verify the contractor is capable of performing the contract.** The purpose is to avoid default.

### Bank Letters of Credit

- The banker examines the quality and liquidity of the collateral in case there is a demand on the letter of credit. If the banker is satisfied that the **contractor can reimburse the bank if demand is made upon the LOC**, there is no further prequalification.



## COVERAGE

### Surety Bonds

- Performance bond - **100% of the contract amount** for project completion.
- Payment bond - **100% of contract amount** protects certain subcontractors, laborers, and materials suppliers and protects owner against liens.
- At least 10% coverage for maintenance of defects the first year after completion.

### Bank Letters of Credit

- The LOC may be obtained for any percentage of the contract, but **5% to 10%** is typical.
- No protection/guarantee that subcontractors, laborers, and materials suppliers will be paid in the event of contractor default. They may file liens on the project.

## CLAIMS

### Surety Bonds

- If the owner declares the contractor in default, the **surety investigates**.
- If the contractor defaults, the **surety's options** are to:
  - ▶ Finance the original contractor or provide support;
  - ▶ Takeover responsibility for completion (up to penal sum of bond);
  - ▶ Tender a new contractor; or
  - ▶ Pay the penal sum of the bond.
- With payment bonds, the **surety pays the rightful claims** of certain subcontractors, laborers, and suppliers up to the penal sum of the bond.

### Bank Letters of Credit

- The bank will **pay on an LOC upon demand** of the holder if made prior to the expiration date.
- There is **no completion clause** in an LOC. The task of administering completion of the contract is left to the owner.
- The **owner must determine the validity of claims** by subcontractors, laborers, and materials suppliers. If there is not enough money from the LOC to pay all of the claims, then the owner has to decide which claims will be paid and which will be rejected.

# 10 Things You Should Know About Surety Bonds

Making the right choice to mitigate and manage risk on construction projects and selecting the most fiscally responsible option to ensure timely project completion are imperative to a successful project – and a sound business. Gambling on a contractor or subcontractor whose level of commitment is uncertain or who could become bankrupt halfway through the job can be an economically devastating decision. Surety bonds offer the optimal solution: providing financial security and construction assurance by assuring project owners that contractors will perform the work and pay specified subcontractors, laborers, and material suppliers.

1

A surety bond is a three-party agreement where the surety company assures the obligee (owner) that the principal (contractor) will perform a contract. Surety bonds used in construction are called contract surety bonds.

2

There are three primary types of contract surety bonds. The **bid bond** provides financial assurance that the bid has been submitted in good faith and that the contractor intends to enter the contract at the price bid and provide the required performance and payment bonds. The **performance bond** protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions. The **payment bond** assures that the contractor will pay certain workers, subcontractors, and materials suppliers.

3

Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms regulated by state insurance departments. However, traditional insurance is designed to compensate the insured against unforeseen adverse events. The policy premium is actuarially determined based on aggregate premiums earned versus expected losses. Surety companies operate on a different business model. Surety is designed to *prevent* loss. The surety prequalifies the contractor based on financial strength and construction expertise. Since the bond is underwritten with little expectation of loss, the premium is primarily a fee for prequalification services.

4

Since 1893, the U.S. Government has required contractors on federal public works contracts to obtain surety bonds to guarantee they will perform such contracts and pay certain subcontractors and suppliers. This law is known as the Miller Act (40 U.S.C. Section 3131 to 3134), and requires a contractor on a federal project to post two bonds on contracts exceeding \$100,000: a performance bond and a labor and material payment bond. A corporate surety company issuing these bonds must be listed as a qualified surety on the **Treasury List**. Also, almost all 50 states, the District of Columbia, Puerto Rico, and most local jurisdictions have enacted similar legislation requiring surety bonds on public works. These generally are referred to as "Little Miller Acts." Owners of private construction also manage risk by requiring surety bonds.



5

Construction is a risky business. Of 853,000 contractors in business in 2002 only 610,000 were still in business in 2004 – a 28.5% failure rate. Surety bonds offer assurance that the contractor is capable of completing the contract on time, within budget, and according to specifications. Specifying bonds not only reduces the likelihood of default, but with a surety bond, the owner has the peace of mind that a sound risk transfer mechanism is in place. The burden of construction risk is shifted from the owner to the surety company.

6

Surety bond premiums vary from one surety to another, but can range from one-half of one percent to three percent of the contract amount, depending on the size, type, and duration of the project and the contractor. Typically, there is no direct charge for a bid bond. In many cases, performance bonds incorporate payment bonds and maintenance bonds.



7

The surety company's rigorous prequalification of the contractor protects the project owner and offers assurance to the lender, architect, and everyone else involved with the project that the contractor is able to translate the project's plans into a finished project. Surety companies and surety bond producers have been evaluating contractor and subcontractor performance for more than a century. Their expertise, experience, and objectivity in prequalifying contractors is one of a bond's most valuable attributes. Before issuing a bond, the surety company must be fully satisfied, among other criteria, that the contractor has:

- good references and reputation;
- the ability to meet current and future obligations;
- experience matching the contract requirements;
- the necessary equipment to do the work or the ability to obtain it;
- the financial strength to support the desired work program;
- an excellent credit history; and
- an established bank relationship and line of credit.



8

Contractor default is an unfortunate, and sometimes unavoidable, circumstance. In the event of contractor failure, the owner must formally declare the contractor in default. The surety conducts an impartial investigation prior to settling any claim. This protects the contractor's legal recourse in the event that the owner improperly declares the contractor in default. When there is a proper default, the surety's options often are spelled out in the bond. These options may include the right to re-bid the job for completion, bring in a replacement contractor, provide financial and/or technical assistance to the existing contractor, or pay the penal sum of the bond. Evidence of owners being shielded from risk is evidenced by surety companies having paid nearly \$9 billion due to contractor failure on bonded projects since 1992, and half of that was paid in the last three years, according to The Surety & Fidelity Association of America, Washington, D.C.

9

When bonds are specified in the contract documents, it is the contractor's responsibility to obtain them. The contractor generally includes the bond premium amount in the bid and the premium generally is payable upon execution of the bond. If the contract amount changes, the premium will be adjusted for the change in contract price. Contract surety bonds are a wise investment – providing qualified contractors and protecting public owners, private owners, and prime contractors from the potentially devastating expense of contractor and subcontractor failure.

After analyzing the risks involved with a construction project, consider how surety bonds protect against those risks. Owners, lenders, taxpayers, contractors, and subcontractors are protected because:

10

The contractor has undergone a rigorous prequalification process and is judged capable of fulfilling the obligations of the contract;

- Contractors are more likely to complete bonded projects than non-bonded projects since the surety company may require personal or corporate indemnity from the contractor;
- Subcontractors have no need to file mechanics' liens on private projects when a payment bond is in place;
- Bonding capacity can help a contractor or subcontractor grow by increasing project opportunities and providing the benefits of assistance and advice of the surety bond producer and underwriter;
- Surety companies may prevent default by offering technical, financial, or management assistance to a contractor; and
- The surety company fulfills the contract in the event of contractor default.

For more information about surety bonding, please contact:



**Surety Information Office (SIO)**

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*The Surety Information Office is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles, and answer questions on contract surety bonds. SIO is supported by The Surety & Fidelity Association of America*

# GUIDE TO BEST'S FINANCIAL STRENGTH RATINGS

A Best's Financial Strength Rating is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. The rating is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile.

## Financial Strength Ratings

	Rating	Descriptor	Definition
S	A++, A+	Superior	Assigned to companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.
	A, A-	Excellent	Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.
	B++, B+	Good	Assigned to companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.
	B, B-	Fair	Assigned to companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
	C++, C+	Marginal	Assigned to companies that have, in our opinion, a marginal ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
R	C, C-	Weak	Assigned to companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is very vulnerable to adverse changes in underwriting and economic conditions.
	D	Poor	Assigned to companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations. Financial strength is extremely vulnerable to adverse changes in underwriting and economic conditions.
	E	Under Regulatory Supervision	Assigned to companies (and possibly their subsidiaries/affiliates) placed under a significant form of regulatory supervision, control or restraint - including cease and desist orders, conservatorship or rehabilitation, but not liquidation - that prevents conduct of normal, ongoing insurance operations.
		In Liquidation	Assigned to companies placed in liquidation by a court of law or by a forced liquidation.
		Suspended	Assigned to rated companies when sudden and significant events affect their balance sheet strength or operating performance and rating implications cannot be evaluated due to a lack of timely or adequate information.

## Rating Outlooks

Assigned to an interactive Financial Strength Rating (A++ to D) to indicate its potential direction over an intermediate term, generally defined as 12 to 36 months.

Positive	Indicates possible rating upgrade due to favorable financial/market trends relative to the current rating level.
Negative	Indicates possible rating downgrade due to unfavorable financial/market trends relative to the current rating level.
Stable	Indicates low likelihood of a rating change due to stable financial/market trends.

## Rating Modifiers

Modifier	Descriptor	Definition
u	Under Review	Indicates the rating may change in the near term, typically within six months. Generally is event driven, with positive, negative or developing implications.
pd	Public Data	Indicates rating assigned to insurer that chose not to participate in A.M. Best's interactive rating process.
s	Syndicate	Indicates rating assigned to a Lloyd's syndicate.

## Affiliation Codes

Indicates rating is based on a type of affiliation with other insurers. | g | Group | p | Pooled | r | Reinsured

## Not Rated Categories

Assigned to companies reported on by A.M. Best, but not assigned a Best's Rating.

NR-1: Insufficient Data.	NR-2: Insufficient Size and/or Operating Experience.	NR-3: Rating Procedure Inapplicable.
NR-4: Company Request.	NR-5: Not Formally Followed.	

## Rating Disclosure

The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance obligations. The ratings are not assigned to specific insurance policies or contracts and do not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information. For additional details, see A.M. Best's *Terms of Use* at [www.ambest.com](http://www.ambest.com).

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## Financial Size Categories (FSC)

To enhance the usefulness of our ratings, A.M. Best assigns each letter rated (A++ through D) insurance company a Financial Size Category (FSC). The FSC is designed to provide a convenient indicator of the size of a company in terms of its statutory surplus and related accounts.

Many insurance buyers only want to consider buying insurance coverage from companies that they believe have sufficient financial capacity to provide the necessary policy limits to insure their risks. Although companies utilize reinsurance to reduce their net retention on the policy limits they underwrite, many buyers still feel more comfortable buying from companies perceived to have greater financial capacity.

<b>Financial Size Category</b>		
<b>FSC</b>	<b>Adj. Policyholder Surplus \$ Millions</b>	<b>Adj. Policyholder Surplus \$ Millions</b>
	Less than 1	250 to 500
II	1 to 2	500 to 750
III	2 to 5	750 to 1,000
IV	5 to 10	1,000 to 1,250
V	10 to 25	1,250 to 1,500
VI	25 to 50	1,500 to 2,000
VII	50 to 100	2,000 or greater
VIII	100 to 250	