First-demand surety bonds:
How we may underwrite them and avoid abusive claims: tools to be used and roles to be performed by the insurer

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SUMMARY

Currently, Brazil is a country marked by good investment opportunities, boosted mainly by the government’s investment in infrastructure projects and the large sports events to be held in the near future. Combining the country's momentum with the inclusion of surety bonds as one of the possible guarantees to be presented for the bidding processes of the upcoming events, the growth potential of this market sector is great. In a growing global surety scenario, insurers will play roles different than that of the good payer, absorbing some good practices from developed markets, avoiding abusive first-demand claims. The fair use of the indemnity agreement, creating the obligation of payment straight from the principal to the insured, the correct use of risk control prior or after the policy issuance, and the creation of a claim expectation phase in the triangular relationship of surety bonds, anticipating some of the steps usually and standardly used for adjusting a regular claim, will be useful methods to avoid abusive first-demand claims and satisfy all parties of the triangular relationship. By adequately using the tools described above, the insurer might play roles different from the one of issuing bonds to provide a final and comfortable solution for all the parties involved without being prejudiced by abusive first-demand claims.

1. QUICK INTRODUCTION TO THE SURETY BOND ENVIRONMENT IN BRAZIL

As the owner of the largest economy with the most ambitious perspectives in Latin America, as per the most exigent analysis of the managers of the global economy, Brazil currently presents a multifaceted scenario of investment possibilities.

In the current globalized scenario, which we are demanded to revere for the sake of good intercontinental relationships, the good moment lived by the country attracts the interest of big investors, either local or foreign.

Nowadays, the economy in Brazil is driven by various factors, the three most important ones being (i) construction and infrastructure projects, (ii) oil derivatives development and (iii) the Soccer World Cup and the Olympic Games to be held in the country in the near future.

The construction sector is now in an excellent phase. Federal government projects which aim to provide achievable conditions for the lowest income layers of the population, as well as the good credit conditions provided by *Caixa Econômica Federal* (Brazilian Federal Bank), have transformed civil construction in Brazil into a very profitable business.

Also highlighted are Petrobras and its influence on the global oil economy. The exploration of the increasingly rare oil sources requires the development of new technologies and multiple kinds of services.

Finally, Brazil has received two presents from international sports associations. The first, from FIFA, is the Soccer World Cup to be held in 2014. The second, from the International Olympic Committee, is the Olympic Games to be held in Rio de Janeiro in 2016. Huge investments not only in sports but also in infrastructure, transportation, sanitation and public security will be required for the events.

It is currently unimaginable that this kind of event may be supported by public capital only. However, it is important to emphasize that the investments required will be managed by the government, i.e. a huge volume of bidding processes are to be launched in the next years. According to Brazilian Federal Government data[1], it is estimated that between 2011 and 2014, BRL 958,9 million will be invested in Brazil and after 2014, BRL 631,6 million more which, after five years, represents the total invested amount of BRL 1,59 billion , corresponding approximately to USD 800 billion.

In the current globalized scenario, constructors in charge of performing large construction contracts are usually required to provide robust guarantees to cover the contract's performance.

To comply with this requirement, a surety bond is a very robust option considering that behind the issued policies there are very solid and reliable structures of insurance and reinsurance companies which will honor the contractual obligation in case of default.

In the Brazilian current scenario, the surety bond industry is the sector of the economy which shows the most reliable growth ratio. On the one hand, the country has not yet passed specific laws to govern surety bonds, although a bill has been submitted for approval. On the other hand, the Brazilian insurance and reinsurance regulator, SUSEP, an autonomous agency reporting to the Brazilian Ministry of Treasury, is the surety regulatory body and issues the corresponding circulars and resolutions.

One of the most important steps towards the creation of a more robust legal framework applicable to surety bonds in Brazil was taken in 1994, when the Federal Law number 8.883 expressly included surety bonds in the list of guarantees which can be bought by the contractor

[1] Brazilian Ministry of Tourism Web site (http://www.copa2014.turismo.gov.br/copa/noticias/todas_noticias/detalhe/20100331_02.html).

(Section 56[2]). This ensures that surety bonds are a reliable and acceptable guarantee for public contracts, at the same level of the existing ones.

2. SURETY BOND BUSINESS STRUCTURE

As is well known, three parties are involved in the surety bond contract: the principal, who takes out the surety bond and is responsible for the performance of the contractual object; the insured, who is the beneficiary of the surety bond, and the insurer.

In this triangle, the relationship between principal and insured is governed by the guaranteed contract, the relationship between the insured and the insurer is governed by the surety bond, and the relationship between principal and insurer is governed by the indemnity agreement, which provides for indemnity payment in case of a paid claim.

For the execution of the indemnity agreement, the claimed bond, as well as other documents defining the amount due to the insurer, should be attached.

In the Brazilian jurisprudence it is well established that the indemnity agreement, although being formally perfect, cannot be considered as an extrajudicial executory instrument, being only evidence of the execution process, as can be illustrated by the decision below:

"*CIVIL APPEAL – EXECUTION – "SURETY INSURANCE" – ABSENCE OF LEGAL REQUIREMENTS – INTERPRETATION OF SECTION 618, SUBSECTION I OF THE BRAZILIAN CODE OF CIVIL PROCEDURE – EXECUTION EXTINCTION – FINAL DECISION. APPEAL REJECTED. The surety insurance contract, although being formally perfect, does not include the essential requirements to be classified as an extrajudicial executory instrument, and as such the execution cannot proceed."* [3]

As the direct execution of the indemnity agreement is impossible, and considering that this agreement represents only a fiduciary guarantee, based on the risk analysis prior to each bond issuance, the principal should be required to sign other collateral indemnity instruments which, if the legal requirements are observed, shall bind the principal to reimburse the insurer for the indemnified amount, *e.g.* financial instruments, real state, industrial machinery and receivables. Depending on the legislation of the country in which the agreement is executed, a surety bond contract shall be considered an extrajudicial executory instrument, in which case the reimbursement would be much faster.

Regardless of the existence of indemnity agreements, the insurer is not entitled to refuse payment or bind the payment to the execution of the contract when the relationship between the insurer and the insured is governed only by the issued bond. This relationship is independent of the one between the insurer and the principal, which is governed by the indemnity agreement. Indemnity agreements are only an alternative way of pursuing reimbursements.

The suggested strategy to make this kind of agreement more robust to avoid abusive first-demand claims is turning the execution of these documents mandatory for the insurer at least when a first-demand bond is to be issued for the principal. Especially in these cases, a clause binding the principal to pay the claimed amount straight to the insured, once the first-demand claim has been submitted, should be included.

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[2] Section 56. Surety insurance for works, services and procurement contracts may be required at the competent authorities' judgment and when the call for bids provides for it (…) II Surety Insurance.

[3] **CIVIL APPEAL No. 137,170, LONDRINA- 3rd Jurisdiction**, where J. MALUCELLI SEGURADORA S.A. files an appeal against MERCOLUZ CONSTRUÇÕES ELÉTRICAS LTDA.

The insurer shall verify whether the formal requirements of the notice have been met, according to the type of bond issued. In the best-case scenario, if the principal agrees to pay the claimed amount, all parties will be quickly satisfied and no reimbursement, dispute or subrogation concerns will arise.

According to the above-mentioned analysis, the insurer may use some suggested tools to avoid abusive first-demand surety payments without posing any doubts on the insurer's liability to pay its obligation if deemed necessary.

3. RISK CONTROL

Risk control and follow-up are quite common practices for surety bond contracts in countries where the surety sector has an important market share.

The object of the contracts executed between the insured and the principal includes such a large number of different clauses, obligations and performance conditions involving increasingly different types of operation standards and steps to be taken that it was concluded that an expert's view on certain kinds of activity is inseparable from bond issuance.

The nature of first-demand bonds and the higher amount paid once a claim notice has been submitted to report a loss event will lead to the conclusion that the adoption of risk control as a standard requirement for bond issuance and for following up the activities under the guaranteed contract will substantially reduce the insurer's risks when a claim is received.

Risk control is an activity regulated by the government. The Brazilian regulator does not allow the insurer to provide risk control services and states that they have to be rendered by another company. However, there are no restrictions for both entities to be controlled by the same parent company.

We suggest that risk control should be performed prior to the bond underwriting process. The reports issued by the risk control experts, together with the documents analyzed in the underwriting process, will show a conservative risk analysis, which may help the insurance company to avoid issuing a bond with criteria applicable exclusively to first-demand bonds. Risk controllers shall suggest new directions or steps to be taken aiming to correct any contractual or operational aspects to adapt the bond to the insurer's criteria and issuance procedures.

If after the risk control analysis prior to the bond issuance the insurer decides to go ahead and issue the bond covering the risks of certain contract, it is suggested that the activity be monitored and followed up by experts' visits. Experts shall suggest, on behalf of the insurer and based on the expertise they have in their surveying activities, new directions or steps to be taken aiming to avoid a potential claim event.

Risk control experts make an important technical contribution to the underwriting process, and the accuracy of the information provided by them helps the insurer to evaluate risk exposure and, in case of a first-demand claim, to avoid abuses.

4. CLAIMS AND THEIR ADJUSTING PROCEDURES

In order that the results of the claim-handling procedure and the satisfaction of the three interested parties converge, it is necessary that the insurer provide a structure to solve the claim in the fastest and fairest way possible without any prejudice to any of the parties.

This paper does not intend to release insurance companies from their obligation to indemnify the beneficiary, but only to explore tools to avoid a notice of claim and achieve a result satisfactory to all parties, which could be compared to the indemnification of the insured and the

immediate reimbursement of the insurer. The simple and immediate payment of the claim is not, however, the only way to solve the apparent conflict of interest.

The role the insurer should perform during the effective term of the bond goes beyond the limits of the indemnification at the moment of receiving the first-demand claim.

It is advisable for the insurer to act as a mediator of the different interests of both the principal and the insured. The suggested structure for the claim-handling procedure is very similar to the one of a legal dispute where there is conflict of interests between the parties (in this case, the insured and the principal) and a third and impartial party suggests a solution for the case; here, the insurer guarantees the rights of appeal and full defense.

By adopting the suggested structure, the insurer also obtains the right to request evidence, mainly documentary, of the arguments presented by the parties, which may provide a faster and fairer understanding of the conflict.

The request for proving the allegations of both parties by the insurer will hardly ever vary from the following scenarios: (i) the insurer confirms the amount due and declares that it is responsible for the claim indemnification after having verified that the amount claimed is within the bond limits, (ii) the insurer confirms that the amount due by the principal to the insured is not its responsibility after having verified that the claim does not fall within the limits established in the bond.

Based on the theory of the satisfaction of all the parties of the surety bond triangular relationship and considering the mediator role assigned to the insurer in the claim-adjusting procedure, the insurer has the responsibility of solving the conflict regardless of the assumptions on which the loss event is based.

The final claim-adjusting report aims to add seriousness, substantiation, fairness and agility, through which legal support is achieved faster than in a lawsuit to solve the dispute.

If it is finally certified that the claimed amount is to be paid by the insurer, the principal should pay the amount due straight to the insured thus avoiding delay fees and penalties, and creating a satisfactory environment for all three parties involved. This decision to pay should be based on documentary evidence that the claimed event is covered by the issued bond.

Taking into account the number of claim notices handled by an insurer, its experience in dealing with this kind of situation can be determined. For example, in the Brazilian environment the insurer's obligation is to verify whether the amount due by the principal to the insured, which would become the insurer's obligation in case of default, is covered by the bond. In addition to making a direct payment, the insurer might suggest other ways to comply with the obligation, which the other parties may accept or not.

If at the end of the process the principal decides to pay the amount due straight to the insured, the principal will be satisfied because the claim against it will not be filed in the insurers' registry so that the principal remains qualified to issue bonds to guarantee its future operations. The insurer will also be satisfied for not having to immobilize its reserves to solve the case as well as for having avoided the filing of a formal claim against it with the regulator.

As aforesaid, after verifying the documents to prove the allegations of both parties regarding the claimed amount, there is also the possibility of concluding that payment is not the insurer's obligation according to the bond coverage and therefore, the debt will not be characterized as a formal claim for regulatory purposes.

If the insurer does not play its role as to suggest a different solution to solve the claim and rejects payment based on its sole criterion, its decision will be against the proposed mediation culture and will satisfy only one party to the process, the insurer itself.

In this case, the insurer shall inform the parties about its understanding of the claim duly justifying its refusal to pay. However, it may–according to its expertise in solving this kind of conflict–suggest alternative paths to fulfill the obligation, aiming to provide a proper solution for the conflict.

The solution suggested by the insurer, if adopted by the principal with the insured's consent, might satisfy the three parties involved in the claim.

In order to provide the fairest possible solution to solve the claim, the insurer should offer the principal and the insured equal conditions for presenting their arguments, so that its advice can be as consistent as possible.

With respect to the deadline issue, if it has been verified that the deadline is over and the solution or suggestion given by the insurer failed to satisfy all the parties of the triangular relationship, the insurer must immediately pay or refuse to pay according to the terms of the issued bond. So the solution for the claim would be the standard one.

This is not an easy culture to be implemented. It is believed, however, that the adoption of the proposed procedures may significantly mitigate the insurer's possibilities of spending capital to solve a first-demand claim scenario. The received information facilitates the eventual abuse verification in the first-demand claim submitted by the insured.

Based on the assumption that the insurer wants to be informed about any adverse event during the covered operation, it is understood that the alert from the insured or the principal, according to the legitimacy which was granted to it when it was elected by the parties as insurance company to issue the bond, shall be given in one of these two forms: the formal claim notice or the claim expectation notice, which will be discussed together with the insurer's role below.

5. CHARACTERIZATION OF THE EXCEPTION – FINAL FIRST-DEMAND CLAIM-ADJUSTING REPORT

The formal claim is the notice received by the insurer informing about the occurrence of a loss event which has given rise to the claim, up to the limit of the issued bond.

However, Gladimir Adriani Poletto understands that first-demand claims will be valid if "the description of the event, the documents supporting the principal's default, the policy, the guaranteed contract and exhibits are attached to the claim notice."[4] So, the claim notice will not be valid unless supporting documentation is attached.

Still in Poletto's understanding, there are some kinds of bonds which do not require this list of documents and information, but only the

"…*presentation of a simple payment request; however, as provided for in the insurance regulations this procedure is deemed to be executory notwithstanding the existence of first-demand bonds, which do not allow the insurer to promote the inquiry and the configuration of the claim because, as suggested by their name, are paid at the simple request of the insured."*[5]

Compared to the traditional types of bonds, this one represents a larger risk of abuse in the insured's claim.

The extremely short deadline for providing the solution to the claim requires that the insurer be prepared before the loss event occurs.

[4] POLETTO, Gladimir Adriani. *O Seguro Garantia em busca da sua natureza jurídica*. Rio de Janeiro: FUNENSEG – Cadernos de Seguro, 2003. p.60.
[5] Ibid.

Whenever the insurer receives a notice of a potential claim event, such as the expected nonperformance of some acts, the insurer is suggested to take a step called “claim expectation.” The insurer, according to its experience, will be able to suggest the necessary measures to avoid the formal claim notice. For this to be possible, the information will have to be provided to the insurer on a timely and accurate basis.

For the insurer’s role in the contracted operation to be healthy and effective, it is necessary that the principal and the insured understand that the insurer wants to be informed. However, there is no need for informing the insurer about every single detail of the process but only of the events or potential events which, if not solved, will lead to a claim.

As there are no objective criteria for the informant’s way of reporting to the insurer, any potential claim event report may vary from case to case. However, the informant should be aware of the consequences derived from inaccurate information.

From the time perspective, we are also faced with a subjective issue. The reason for this is that if there is a claim expectation scenario, the deadline to solve the conflict, a potential cause for a claim in the future, is not provided by law or regulation but is a reasonable and private term.

So, the amount and timeliness of the information received by the insurer are the two factors that may determine its course of action. In any case, the insurer has to justify the adoption of its proposal aiming to achieve full performance of the guaranteed contract and creating an environment in which the parties feel comfortable to perform their obligations.

The suggested actions for the claim-adjusting procedure should be advanced, which will allow the insurer to take decisive action prior to the submission of the claim.

Although at this stage the insurer’s objective is to satisfy all the parties and prevent the filing of a claim, equal chances for the insured and the principal to present their arguments must also be available, so that the parties may state their opinion about the loss event and justify their positions.

Any suggestion provided by the insurer is not binding for the parties involved. It is understood, however, that there are strong possibilities of mitigating the claim occurrence if the insurer’s proposal is adopted, considering its expertise, the analysis of both parties’ arguments, its fairness and market knowledge to make such proposal.

It is important to emphasize that the adoption of any procedure described hereto neither intends to mitigate the effects of an eventual claim nor release the parties to a surety bond relationship from their liabilities. The suggestions described hereto only aim to create an alternative claim-adjusting scenario. The insurer plays an important role in keeping the principal’s and insured’s reputation unblemished if they choose to follow the insurer’s suggestion, which may be positively reflected in its future risk analysis as well as in the issuance of future bonds for them.

6. CONCLUSIONS

With Brazil in the investment world scenario and having expectations of higher economic growth boosted by the next Olympic Games, the Soccer World Cup, and oil and government investments on infrastructure, surety bonds represent an increasingly significant market share.

Not having a very developed legal and regulatory framework, the surety bond in Brazil is an industry under construction which operates following international standards. Based on this, the technical aspect of this line of the insurance market has developed and brought to Brazil a kind of surety bond which restricts the possibility for the insurer to follow claim adjustment procedures and enables it to demand immediate payment, i.e. the first-demand surety bonds. For

this kind of surety bond claim not to be abusive, some steps to be taken by the insurer are suggested.

In view that when a surety bond is issued, the main benefit for the insured is that its assets are not immobilized during the performance of a contract, the indemnity agreement, which is the instrument governing the relationship between the insurer and the principal, shall be mandatory for first-demand bond issuance and shall contain a clause establishing the obligation of the principal to pay the claimed amount straight to the insured whenever a claim is received. The role of the insurer is limited to verifying whether the formal requirements have been fulfilled.

The use of risk control, which is a common practice for surety bonds in developed countries prior to the bond issuance and during the underwriting procedure, will identify the risks according to the operation to be covered using the expert's view, which might prevent divergent scenarios and the underwriting of a risk out of the insurer's appetite, and help set pricing as well. After deciding for the bond issuance and during the effective term of the bond, risk control should be an activity to be periodically performed, aiming to know in advance about the existence of any event which can lead to a claim.

The insurer's experience in dealing with this type of conflict of interests creates a new role for the insurer, the role of mediator. Under this scenario, the principal and the insurer should timely provide the information deemed to cause a potential contract concern so that the insurer may properly anticipate the steps to be taken for adjusting a claim on a standard basis and structure the claim expectation phase. Then, the parties and the insurer will have the opportunity of discussing the event implications, trying to avoid a formal claim and finding a way of solving the apparent conflict in advance.

With the adoption of the suggested culture, the insurer would substantially mitigate the risks of receiving abusive first-demand claims. Once the availability of these steps has been verified, they will also be really useful for the underwriters to be more comfortable when issuing first-demand surety bonds.