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The History and Economics of Suretyship*

BY WILLIS D. MORGAN†

THE CORPORATE SURETY IN AMERICA.

The Guarantee Society of London had been enjoying a prosperous existence for more than twenty years before the first surety company made its appearance in the United States. The explanation of this is primarily one of economic development; while the corporate surety was passing through its period of experimentation in England we were still a new country, devoted largely to agriculture and thus not in need of an institution which lends itself more to industry and finance. During this period, too, our attention was drawn to other things,—the constant movement of the frontier westward, the Mexican war, the discovery of gold in California and, most important, the ever burning question of slavery. Add to these reasons the Anglo-Saxon suspicion of new things, which we are said to have inherited, and, in a measure, we may understand the late coming of the corporate surety to America.¹

In the New York Public Library is to be found the prospectus² of the Fidelity Insurance Company, the first company of its kind to operate on the North American continent. This company received its charter on April 7, 1865, and had its offices at 170 Broadway, New York City. Its prospectus positively states that "This company is the first established in the United States to obviate the inconvenience and defects of Suretyship by private Bondsmen . . .". Then, much in the vein of the announcements of the early English companies and of the articles by those English pioneers, De Morgan, Saunderson and Knight, it continues, "Persons of the highest character and qualifications frequently decline valuable appointments, either from an unwillingness to place themselves and their friends under so serious an obligation, or the difficulty of obtaining satisfactory sureties; but the chartering of this company removes these dif-

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¹Conflicting state legislation has been given as an additional cause for the slower development of various types of insurance in the United States. GEPHART, *INSURANCE AND THE STATE* (1913) 5.

²Printed by D. A. Woodworth, 137 Nassau St. and 9 Beekman St., New York City.

faculties. . . . This company, for a small yearly payment, undertakes to make good to the Employer any loss by the fraud or dishonesty of the person Employed, according to the amount specified in the Bond, and therefore obviates the necessity for private sureties, as well as the evils arising therefrom. . . . Employers by the existence of this Company, are assured of the continued solvency of the surety for the person employed, and the security thus becomes a permanent one and friends and relatives are relieved from the fear of pecuniary losses, to which persons are exposed who become responsible for the acts of others." The prospectus concludes with a short history of the corporate surety in England, a statement of the reasons why the bond of a corporate surety was preferable to that of a private person, a list of the "banks, corporations and firms" which approved the corporate bond and a statement of the rates to be charged by the new company.

This company proposed to confine itself to the writing of fidelity risks and thus was merely following its English predecessors. The very language of its prospectus is only an adaptation from the English writings on the subject. But in America it was in advance of its time and soon ceased operations.³ Its only contribution was its initial effort to bring here an institution which already had found favor in the Old World.

The history of this company is found in fairly complete form, but as to others of the "first companies" in the United States, we are not so fortunate and must content ourselves with a few widely scattered and fragmentary references. One such reference, which appears in an issue of the *Bankers' Magazine* for 1879, reads, "In Pennsylvania, there are two companies which have a right, under their charters, to engage in fidelity assurance. One is the Fidelity Insurance, Trust and Safe Deposit Company, organized in 1866. The other is the Guarantee, Trust and Safe Deposit Company, organized in 1872."⁴ Thus it would appear that, in the year following the incorporation of the Fidelity Insurance Company, a similar company had been started in another state. Apparently it had prospered, since it was still in existence in 1879 when this article was written. But, as further appears, these companies had confined their activities to the writing of court bonds. "They have neither

³A note upon this prospectus, dated June 25, 1923, and signed by D. Brayson Delavan, M.D., reads, "The Fidelity Insurance Co. was founded in 1866 in the city of New York by Edward Close Delavan, Attorney at Law. It was the first institution of its kind in the United States and it was discontinued after a short existence because in advance of its time. . . ."

⁴34 *BANKERS' MAGAZINE* 423.

of them, . . . engaged as yet in the general business of fidelity assurance, although they have both, as we are informed by a well-advised correspondent, become sureties to courts for executors and trustees."⁵ These companies are not listed in the insurance year books of subsequent years as fidelity insurance or surety companies and the inference is that they passed out of existence, or ceased to do a surety business, or perhaps assumed new names under which they were so listed.

The Citizens Insurance Company, which commenced business in 1868, was authorized to write fidelity insurance and was the first of the Canadian companies.⁶ Due to a conservative selection of risks, its operations were successful, but about 1881 it discontinued this branch of its business, arranging with the Canadian Guarantee Co. to assume its risks.⁷ The latter, the second of the Canadian companies, received its charter in 1871 and was the first company, surviving to the present day, to conduct a surety business on this continent.⁸ Unlike the English companies, it did not bond public officials, but "limited its guarantees to officers of banks, railroads and other corporations,"⁹ and also, contrary to the policy of many of its predecessors and of the later American companies, it did not undertake other lines of insurance; its "whole capital and funds" were applicable to its main undertaking.¹⁰ In 1881 the name of this company was changed to the "Guarantee Company of North America," under which name it has continued to the present day.¹¹ On February 7, of the same year, it was admitted to transact business in New York.¹²

The financial statements of this company for the years 1880 and 1885¹³ reflect favorably upon its progress. In the former year it received in cash premiums \$52,368 and paid out in losses \$40,929, while in the latter year its cash premiums increased to \$195,678, and its losses only to \$65,302, representing an increase of about three hundred per cent in cash premiums and a corresponding increase of but sixty per cent or thereabouts, in losses. The explanation of this phenomenal improvement is probably to be found in a better understanding and application of the principles of fidelity underwriting.

⁵*Ibid.* ⁶32 BANKERS' MAGAZINE 592.

⁷INSURANCE YEAR BOOK (1882) 416.

⁸*Supra* note 7; Kirkpatrick, *Guarantee Insurance*, (1908-1909) PROCEEDINGS OF THE INSURANCE INSTITUTE OF TORONTO, 44.

⁹Supplee, *Corporate Surety Bonding*, 2 YALE INS. LECTURES 278.

¹⁰*Supra* note 7, at 32; Dean, *Fidelity and Surety Insurance*, 63 SPECTATOR 120.

¹¹*Supra* note 7.

¹²NEW YORK INSURANCE REPORT, (1881) 176.

¹³INSURANCE YEAR BOOK, (1886) 411.

But the monopoly which the Guarantee Company of North America had enjoyed during its first years was soon interrupted.¹⁴ Five years after its incorporation the Knickerbocker Plate Glass and Accidental Insurance Company received a charter from the state of New York, under which it was authorized to do a general fidelity business.¹⁵ By an act of the legislature of May 15, 1876, its name was changed to the Knickerbocker Casualty Insurance Company, and later, on March 31, 1880, by a similar act, it assumed its present name, the Fidelity and Casualty Company of New York.¹⁶ This company, unlike the Guarantee Company of North America, proposed to carry other than surety lines; its charter, in addition, permitted the writing of plate glass, steam boiler and accident insurance and the insurance of "any contingent event whatever, life, fire and marine risks excepted, which may be the subject of legitimate insurance."¹⁷ Because of this broadness of its charter and the scope and variety of its undertakings, it has been characterized as more an English than an American type of company.¹⁸

The Fidelity and Casualty Co., in addition to fidelity bonds and bonds for administrators and executors, by 1881 had written appeal, replevin and attachment bonds and was the first company in the United States to undertake risks of this nature. It has the added distinction of being the oldest of our present day surety companies, but from its inception it depended more upon its casualty than its surety business and for this reason would be more properly classified as a casualty company.¹⁹

The corporate surety at this stage in its development was confronted with many problems. Capital was not attracted to the business because of its untried nature and the relatively low return which it offered. An article by Mr. Dudley P. Bailey Jr., which appeared in the Bankers' Magazine in 1877, is confirmatory of this. Speaking of the Fidelity Assurance Company of Massachusetts, he says, "The chance of getting only six per cent dividends . . . has not been found a sufficient inducement to attract capital to a new branch of business, and consequently it has not been possible to raise the . . . capital to commence operations."²⁰

But of greater need was the education of the public to the purposes and functions of these companies and the advantages which they

¹⁴The Imperial Guarantee and Loan Society was founded in 1872 but by 1878 had not operated. *Supra* note 6, at 591.

¹⁵ANNUAL CYCLOPAEDIA OF INSURANCE IN THE UNITED STATES (1890) 261.

¹⁶*Supra* note 15.

¹⁷*Supra* note 15 (1891-1892) 70.

¹⁸*Supra* note 17.

¹⁹*Supra* note 15, at 262. *Supra* note 7, at 111.

²⁰*Supra* note 6, at 590, 593.

afforded. The institution was so novel, so utterly a stranger in the family of insurance companies, that people were prone to doubt, not alone its ultimate success, but even the essential soundness of its principles. Mr. Bailey's observations in this regard are illuminating. "The application of the insurance principle," he says, "to cases of moral hazard, involves elements of so complicated a nature, that it is among the latest branches of insurance to be developed. It might seem, indeed, that moral hazards and delinquencies were subject to no law, and that the risk could not be measured with sufficient accuracy to make fidelity an insurable quality."²¹ Nevertheless, the corporate surety was creating interest. The Fidelity Assurance Company of Massachusetts had not succeeded, but its incorporation had prompted the legislature of that state to appoint a committee to investigate the subject of fidelity insurance.²² At this time, too, our literature on the subject had its beginning. Mr. Levy Maybaum, in 1878, published a pamphlet²³ in which he proposed the organization of a company whose main function was to be the issue of bonds comparable with our modern depositary bonds. Four years later Mr. Marshall Kirkman, in a pamphlet entitled, "Mutual Guarantee",²⁴ urged the formation, by the employees of railroads and other large corporations, of mutual fidelity insurance associations, whose purpose would be to replace both the private surety and the surety company,—a kind of self insurance, reminiscent of De Morgan's early ideas on the subject. The insurance year books, too, were making frequent mention of these new companies. Despite the views of the skeptics, the corporate surety was attracting attention and was here to stay. In fact, it was about to enter upon a period marked by the incorporation of many new companies and a broadening and extension of the business.

The first of these advances was made by the American Surety Company, incorporated in the state of New York on April 14, 1884.²⁵ This company, starting with an authorized capital of \$500,000, in the old Guernsey Building at 160 Broadway, the site now occupied by the building of the Lawyers Title and Trust Co., today ranks as one of the leading companies, with about forty branch offices, and subsidiary companies in both Mexico and Canada, and correspondents

²¹*Ibid.* 591.

²²*Supra* note 20.

²³A PLAN OR SYSTEM FOR SECURING PERSONS AGAINST LOSS IN BANKING, FIRE, LIFE AND MERCANTILE INSTITUTIONS, (1878). A copy of this pamphlet may be found in the Library of Congress.

²⁴A copy of this pamphlet is in the Library of Congress.

²⁵NEW YORK INSURANCE REPORT (1885) Part II, 138. AMERICAN SURETY Co. OF NEW YORK (1923) 1-4; INSURANCE YEAR BOOK (1885) 24.

in every important country of the world.²⁶ It was the first modern company, devoted exclusively to surety underwriting, to be organized in the United States. It was also the first of our surety companies to establish a branch office in a foreign country.²⁷ But its principal distinction is to be found in its advances into new fields. Prior to this time contract bonds had been introduced by the English companies, but had not been favorably accepted. The American Surety Company, which had at first confined itself to the fidelity business and later had broadened its operations to include bonds of executors, administrators and other fiduciaries, and appeal, replevin and attachment bonds, about 1887, added the contract bond to its list of obligations. It was the first company on the North American continent to undertake this sort of surety underwriting and, for over half a decade, had practically a monopoly in this line.²⁸

The business of a modern surety company embraces over five hundred varieties of bonds, of which three hundred are in common use. These, however, may be divided into six great classes: namely, (1) the fidelity bond, (2) bonds for executors, administrators and other fiduciaries, (3) bonds used in court proceedings, as appeal, replevin and attachment bonds, (4) contract bonds, (5) license and permit bonds, and (6) public official bonds.²⁹ Fidelity bonds were first written by the Fidelity Insurance Co. in 1865; the second class, broadly known as fiduciary bonds had been written by at least two companies some time prior to 1879;³⁰ the Fidelity and Casualty Co., by 1881, had written court bonds, including appeal, replevin and attachment bonds; some six years later the American Surety Co. had introduced the contract bond; license and permit bonds, comprising the fifth class, probably were first written by the Fidelity and Casualty Co. in 1890. There yet remained, however, as an untried venture, the bonding of public officials.

Less than two years after the Guarantee Society of London had been incorporated, by an act of Parliament that company was permitted to issue bonds for public officials, and this branch of the business proved a lucrative field for the early English companies. But our companies had not so readily received governmental approval.

²⁶*Supra* note 25.

²⁷A branch office was opened in Canada in 1887. INSURANCE YEAR BOOK (1888) 162.

²⁸Advertisement, INSURANCE YEAR BOOK (1885) 16; *Supra* note 9, at 274; Dean, *loc. cit. supra* note 10.

²⁹For classifications of the various bonds see, Blanchard and Moore, *Corporate Bonding*, PROCEEDINGS OF THE CASUALTY ACTUARIAL AND STATISTICAL SOCIETY OF AMERICA, Vol. VII, Part I, No. 15, 23; Lunt, SURETY BONDS 60-322.

³⁰The Fidelity Insurance, Trust and Safe Deposit Company and the Guarantee, Trust and Safe Deposit Company.

The first recognition accorded them by the federal government is contained in an act of Congress, passed on August 13, 1894,³¹ or nearly thirty years after the first of their number had been incorporated, under which they were permitted to bond persons in the Federal employ. And this was but the beginning, for it was then necessary to carry the campaign into the various states, and it was not until some years later that this work was completed.³²

The first company to avail itself of the new legislation was the Fidelity and Deposit Company of Maryland.³³ This company had been incorporated in Maryland in 1890, under the name of the Fidelity Loan and Trust Company of Baltimore City, but later in that year, by an act of the legislature, had taken its present name.³⁴ By this act, too, its charter was broadened to include the surety business, to "insure the fidelity of persons holding places of trust" and "to become surety for the faithful performance of any trust, office, duty, contract or agreement, and to supervise any judgments or go upon any appeal or other bond."³⁵

The history of this company is intimately associated with the personality of its first president, the late Edwin Warfield. It was he who had discerned the enormous possibilities in the bonding of public officials and it was largely through his influence that the act of Congress of August 13, 1894, above referred to, had been passed. In his article on corporate suretyship, he tells us that he had "determined to make a specialty of becoming surety on the bonds of officers and employees of the United States and of the various states and municipalities."³⁶ This article, too, speaks of his connection with the act of August 13, 1894. "Finally in 1894," he says, "we succeeded in having passed by Congress an act that authorized the approval of corporations as sole surety upon bonds given by public officers, and in all judicial proceedings in the United States Courts."³⁷ We have no record of the precise year during which the first public official bond was written, but we do know that the Fidelity and Deposit Co. was the first to engage in this class of business, and it is safe to say that this was shortly after the passage of the act of Congress, probably not later than the year 1895.³⁸

³¹U. S. Comp. Stat. (1916), § 3293; Arnold, *The Compensated Surety*, (1926) 26 COL. L. REV. 171.

³²Edwin Warfield, *Corporate Suretyship*, in FRICKE, INSURANCE.

³³*Supra* note 9, at 274.

³⁴Laws of Md. (1890). C. 263.

³⁵*Supra* note 34.

³⁶*Supra* note 32.

³⁷*Ibid.*

³⁸The public official bond was in common use by 1899. Dean, *loc. cit. supra* note 10.

The dreams of Mr. Warfield have been more than realized. At first confining its activities to the southern states, particularly Kentucky, North Carolina, South Carolina, Georgia and Virginia, this company soon broadened its operations and now is admitted to do business in every state in the Union. In 1899 it opened a branch office in Havana and in 1901 such an office was opened in London. Since that time its agencies have been established in Russia, Germany, Austria-Hungary, Italy and Hawaii, but the World War required its retirement from all the European countries with the exception of Great Britain.

The period from 1883 to 1898 saw the formation of at least twenty-five new companies, each eager to obtain a foothold in the surety field. The results were to be expected. The conservative companies continued to charge a rate sufficient to cover losses and insure a fair return on the capital invested, but the newer companies, having little or no knowledge of the business, and in frenzied competition, one with the other, cut their rates to a minimum, in many cases with bankruptcy as the result. Thus we find that by 1898, of the original twenty-five companies, only fourteen remained in the field—eleven had either abandoned their surety lines or had ceased operations.³⁹ And conditions did not immediately improve, for in a survey and report to the National Convention of Insurance Commissioners for the years 1906-1907 it is said, "The demand for this kind of protection led, indeed, to the formation of so many companies and brought about such competitive conditions . . . that, prior to 1906, pretty nearly everything connected with fidelity insurance and corporate suretyship was, at least from the standpoint of supervision, in chaos."⁴⁰ It was quite evident that, unless some measures were taken to regulate the business and particularly the rates to be charged by the various companies, they would ultimately work their own destruction.

But no one realized better than the companies themselves the ultimate goal toward which they were traveling and to meet the situation, on November 12, 1908 the Surety Association of America was founded.⁴¹ The purposes of this association may be summarized as follows:⁴² (1) a standardization of the rates to be charged by the member companies; (2) an inclusion in its membership of all properly qualified surety companies; (3) a regulation of commissions and brokerage fees; (4) an elimination of rebates; (5) a limitation of the

³⁹MASON, ORIGIN AND HISTORY OF SURETYSHIP 7; See also *supra* note 38.

⁴⁰HOTCHKISS, AMERICAN LAW AS AFFECTING CORPORATE SURETYSHIP AND SURETY COMPANIES, Dec. 16, 1915.

⁴¹LUNT, SURETY BONDS 13.

⁴²*Supra* note 41, at 16.

number of agencies to be maintained by member companies, and (6) a defeat of legislation injurious to the interest of member companies and the enactment of legislation favorable to them. The first of these purposes was accomplished by the formation, on October 1, 1909, of the Towner Rating Bureau.⁴³ The function of this body is to fix uniform rates, based upon the composite underwriting experience of numerous companies. In the absence of years of underwriting experience, such as that which fire and life insurance have at their disposal, a rate based upon the experience of all, or nearly all of the companies, is the nearest approach to an exact science in that direction which we may now hope for. But even with the steadying influence of these organizations, the mortality among the companies has continued to be alarming. Of some fifty-seven new companies incorporated since 1898, thirty, or more than fifty per cent, have either retired or have abandoned their surety lines.⁴⁴

In England, no steps toward cooperation have been taken. The secretary and manager of the National Guarantee and Suretyship Association, Ltd., in a lecture before the Insurance Society of Edinburgh, on January 16, 1923, said, "I am sorry to say competition has reduced rates to such an extent, in this country, that it is extremely doubtful whether there is any underwriting profit left in what may be termed ordinary commercial guarantees. . . . There are surely many classes of risk for which there should be no difficulty in arranging a scale of appropriate rates and, if necessary, a Rating Committee might be set up to deal with some of the larger commercial risks."⁴⁵ The English companies are today in precisely the same situation as were our companies prior to 1908. Their need, as was ours, is wholehearted cooperation, coupled with an intelligent fixing of rates.

The history of the corporate surety is marked by the enormous proportions which the business has assumed in its short span of eighty-seven years. A survey today shows seventy companies in Great Britain, thirty-five in the United States, two in Canada, two or three in Switzerland, one or two in Germany, one in Denmark, at least one in Sweden, one at Barcelona, one at Johannesburg in Africa, two in Japan, one in Mexico and two in the Argentine, which with their numerous agencies at home and abroad, have introduced the business into almost every important country in the world.⁴⁶ And the business, too, has broadened—in addition to the fidelity bond, which at first was the sole undertaking of these companies,

⁴³*Supra* note 41.

⁴⁴MASON, *op. cit. supra* note 39, at 18.

⁴⁵SMITH, SURETY BONDS 13.

⁴⁶MASON, RADIO TALKS (Season 1923-1924) 11; Mason, *op. cit. supra* note 39, at 8.

there are now bonds for fiduciaries, bonds required in court proceedings, contract bonds, public official bonds, license bonds and many others, comprising some three hundred distinct varieties all of which are in common use—an extraordinary achievement, considering the relatively short existence of these companies. But we may safely assume that the process of expansion is not at an end. The business, comparatively speaking, is still in its infancy; the companies are now finding and will continue to find new fields for their endeavors⁴⁷ and with that added experience, which will be acquired with the years, they will be able to meet the new problems and have a better understanding of the old.

THE FUNCTIONS OF THE CORPORATE SURETY

The functions of surety companies have afforded material for considerable discussion. A few writers consider these companies to be insurers,⁴⁸ while others view them as something unique, a hybrid as it were, devoted neither to insurance nor banking but related perhaps to both.⁴⁹ The courts, however, from the first held them to be insurers.⁵⁰ In *Tebbets v. Mercantile Credit Guarantee Co.*,⁵¹ decided in 1896, it is said:

“Corporations entering into contracts like the one at bar may call themselves ‘guarantee’ or ‘surety’ companies, but their business is in all essential particulars that of insurers, . . . Their contracts are, in fact, policies of insurance, and should be treated as such.”

This view seems entirely justified from an economic standpoint. Insurance has been defined as “. . . that social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of the risks of many individuals to one person or to a group of persons.”⁵² Technical insurance, however, presupposes that the risks to be transferred satisfy certain conditions; namely: (1) that, as to the beneficiary, the happening of the event, upon which the policy is to be conditioned, be an accident; (2) that this event be of such a nature that it is not likely to happen in every

⁴⁷Bonds guaranteeing against forgery are one of the later developments. DUNHAM, BUSINESS OF INSURANCE 508.

⁴⁸Blanchard and Moore, *op. cit. supra* note 29, at 28. TOWNER, PREMIUMS AND RATES, INSURANCE SOCIETY OF NEW YORK, Lecture XI.

⁴⁹Mason, *op. cit. supra* note 39, at 1; MASON, RADIO TALKS, (Season 1923-1924) 9. See also ROULSTON, FIDELITY BONDS, SURETY BONDS, CASUALTY POLICIES 12-13; JOYCE, PROPER RESERVES FOR FIDELITY AND SURETY CLAIMS.

⁵⁰See Arnold, *The Compensated Surety* (1926) 26 COL. L. REV. 177 and cases cited; *supra* note 9, at 280; 60 BANKERS' MAGAZINE 173 (1891); R. R. Brown, CORPORATE SURETYSHIP 2; Mc Rae, *A New View of Suretyship* (1891) 15 VA. L. JOUR. 181.

⁵¹73 Fed. 95, 97 (C. C. A. 2d 1896).

⁵²WILLETT, THE ECONOMIC THEORY OF RISK AND INSURANCE 106.

instance in which a policy is issued, or in any great number of instances at the same time; and (3) that the extent of the loss, in a given number of cases and for a given time, be scientifically ascertainable, to some degree of accuracy, upon the basis of past experience. A risk of this nature, commonly known as a static risk, may be made the subject of insurance.⁵³

The risks with which surety companies are concerned come squarely within this class and the transfer of such risks by many persons to one person or a corporation would seem to constitute insurance. But surety companies, it is said, are to be distinguished from insurance companies. It is first pointed out that a surety company has a right of reimbursement from the principal, while this right is unknown to the ordinary insurance company.⁵⁴ But the right of the company to recoup its losses from a principal who has defaulted does not alter the fact that risks have been transferred, and it is with this that insurance is concerned. Indeed, a somewhat similar right is exercised by fire insurance companies. Under their policies they are subrogated to the rights of the assured against such persons as are responsible for a loss and under this right they frequently are reimbursed for losses which they have sustained. But we would not say that for this reason these companies are improperly classed as insurance companies. A similar claim is made with respect to bonds which are of so hazardous a nature that the companies have found it necessary to demand collateral from the principal to protect them in the event of default. As to these bonds, it is said that the company merely extends its credit to the principal and thus acts more as a bank than as an insurer.⁵⁵ But such a practice on the part of the company is merely for its protection in the event of default. As between the company and the obligee the transaction is the same as if no security were given. The fact is that a risk is transferred and a premium is paid, and the transaction can be viewed only as one of insurance.

The usual insurance policy has but two parties, the company and the assured, while there are three parties to a surety bond, the company, the principal, and the obligee. This distinction is the basis for a further claim that suretyship is not insurance.⁵⁶ But this argument is addressed not so much to substance as to form. When surety companies first began to write their bonds they had as a guide the form of bond used by private sureties, under which the principal was included as a party, and it was but natural that the bonds of

⁵³Haynes, *Risk as an Economic Factor*, 9 QUARTERLY JOURNAL OF ECONOMICS 412, 447; *supra* note 52, at 48.

⁵⁴*Supra* note 49.

⁵⁵*Supra* note 49.

⁵⁶*Supra* note 49.

surety companies should follow this precedent. As a practical matter, there appears to be no necessity for this practice, since the company and the obligee are the only real parties to the surety undertaking. But aside from this, to include the principal as a party in no way changes the essential nature of the transaction as between the company and the obligee. The former is clearly an insurer and the latter the assured.

As a further indication of the true nature of these companies, it is significant that their main function is precisely that of pure insurance. Risks of any nature may be met in three distinct ways: by avoidance, by prevention or by combination. This last method, commonly known as insurance, involves the assumption of risks in return for a fixed premium, and in its final analysis represents an exchange of an uncertain future loss for a present fixed sum. Thus the main function of insurance is said to be to replace the uncertainty of the future with the certainty of the present.⁵⁷ And a surety company, in taking over risks involving the dishonesty or irresponsibility of human beings in return for a fixed sum of money, is performing this very function.

The corporate surety, like every other type of insurance, occasions an economic loss. The gross premiums charged by surety companies may be divided into three parts: (1) provision for the payment of losses, known as the pure premium, (2) provision for the costs of management, and (3) a residual amount which contributes to the surplus of the company. The second of these elements, the costs of management, is a distinct economic loss.⁵⁸ But there are certain economic gains to be attributed to the corporate surety, which may be set off against these losses. These gains are not to be found in a decrease in the number of defalcations. It is true that in the field of fidelity bonds the underwriting practices of surety companies have contributed to bring about such a decrease.⁵⁹ But a defalcation by a principal does not represent an economic loss and it follows that to prevent such defalcations is not an economic gain. It may be added that the decrease referred to cannot be attributed to the insurance function of these companies. It is brought about by preventive means, and prevention is not a function of insurance. On the contrary, they are complementary methods of meeting risks.⁶⁰

⁵⁷*Supra* note 52, at 115; SELIGMAN, PRINCIPLES OF ECONOMICS 76.

⁵⁸Haynes, *op. cit. supra* note 53, at 446. This apparently is the principle economic loss caused by the corporate surety. In other types of insurance there are additional losses.

⁵⁹These practices consist of a certain amount of supervision over the principal and the vigorous prosecution of defaulters. *Supra* note 4, at 423.

⁶⁰*Supra* note 52, at 118.

Risk, with its resulting uncertainty, is an expensive factor in economic life⁶¹ and insurance is a means of removing it. The combination of risks by insurance companies makes possible an application of the law of averages, by means of which the expected loss for the group may be ascertained. And the premium which the company charges is based upon and covers the expected loss. The result is that the only risk borne by the company arises from the possibility that the actual loss will exceed this expected loss. Thus, in place of the great number of individual risks transferred to the company, there is but this one risk, infinitely smaller, which the company alone must bear. It is in so reducing risk and the expenses incident to it that insurance of any type, including corporate suretyship, represents an economic gain. Where this gain is greater than the costs of producing it,⁶² that is, the costs of management, the particular type of insurance is economically sound. That this is true of corporate suretyship is shown by its continued existence and the increasing demand for the protection which it affords.

⁶¹Ross, *Uncertainty as an Economic Factor in Production*, 8 ANNALS OF AMERICAN ACADEMY OF POL. AND SOC. SCIENCE 304; *Supra* note 52, at 50, 107; Haynes, *op. cit. supra* note 53, at 415.

⁶²*Supra* note 52, at 107-112, Clarke, *Insurance and Business Profit*, 7 QUARTERLY JOURNAL OF ECONOMICS 40.