



# COMMERCIAL SURETY BONDS: HOLDING BUSINESSES ACCOUNTABLE

## COMMERCIAL SURETY BONDS ARE ANOTHER POWERFUL TOOL FOR PROMOTING PUBLIC POLICY AND MITIGATING TAXPAYER RISK.

Among other things, commercial surety bonds can be required for licensing and permitting companies to conduct business in a state or locality. Requiring commercial surety bonds as a condition of licensing or permitting protects consumers by giving public agencies added assurance that a company operating within their jurisdiction will comply with state and local laws and regulations.

To understand the value of commercial sureties, look at what's happening to Wyoming's coal mining industry. The state's Powder River Basin is responsible for 40 percent of coal production in the U.S.<sup>14</sup> and holds enough coal to meet global demand for the next 140 years.<sup>15</sup> According to the U.S. Energy Information Administration, 33 states, including Wyoming, receive up to 90 percent of their domestic coal from these mines.<sup>16</sup>

Battered by falling demand for coal and competition from cheap natural gas, the industry is in a steep downturn. Since 2015, three major coal companies have declared Chapter 11 bankruptcy: Alpha Natural Resources, Arch Coal and Peabody Energy.

These bankruptcy filings have serious implications for government agencies and taxpayers. Under a federal law, the Surface Mining Control and Reclamation Act of 1977, mining companies must reclaim land they have mined.<sup>17</sup> However, the law also allows them to "self-bond," meaning they do not have to seek third-party surety bonds to restore the land to its original condition. All that a company must do is prove they are financially solvent enough to pay for the reclamation.

This solvency comes into question when a company declares bankruptcy. In Wyoming, this risk is even more pronounced: Alpha Natural Resources, Arch Coal and Peabody Energy have

millions of dollars in self-bonding obligations within the state. Arch Coal has \$486 million in obligations, while Alpha Natural Resources has \$411 million.<sup>18</sup> Peabody Energy has the largest share of these obligations at \$728 million.<sup>19</sup>

Wyoming's Department of Environmental Quality (DEQ) recently reached an agreement with Arch Coal and Alpha Natural Resources that allows the state to collect what it's owed ahead of the companies' other creditors. However, the state will only get 15 percent of the actual bond amount, which doesn't come close to covering what it will cost to restore these lands.<sup>20</sup> The companies will be allowed to complete the bankruptcy process before they seek third-party bonds to make up the difference, but federal officials have argued that the state's settlement with Alpha Natural Resources in particular could violate mining laws because the company has been allowed to keep operating without securing replacement bonds, even after it failed to financially qualify for self-bonding the prior year.<sup>21</sup>

Kyle Wendtland, the administrator of DEQ's Land Quality Division, says the situation illustrates the pitfalls of self-bonding.

COMMERCIAL SURETY BONDS ARE AN INTEGRAL PART OF THE REGULATORY SCHEME FOR MANY BUSINESSES, OCCUPATIONS AND ACTIVITIES. STATE AGENCIES VALUE THE SURETY'S PREQUALIFICATION IN INDUSTRIES SUCH AS MORTGAGE BANKING, REAL ESTATE, HEALTH CLUBS AND AUTO SALES.



“These events highlight certain systemic problems with self-bonding, but had to be addressed individually and in a timely manner,” Wendtland said in a statement when the state reached a settlement. “DEQ, as the entity with exclusive jurisdiction over the matter, exercised its considerable discretion to enter a settlement that protects the public, the environment and sets a firm timetable for Alpha’s transition away from self-bonds.”<sup>22</sup>

All but five coal-producing states in the U.S. allow self-bonding, according to an Interstate Mining Compact Commission survey.<sup>23</sup> Though only Congress has authority to change the law and prohibit self-bonding, states can choose not to allow it at their own discretion. The Wyoming debacle shows that many of these states may be putting themselves at risk if they don’t do so.

When it comes to hundreds of millions of taxpayer dollars, the financial stress tests required for self-bonding aren’t enough to appropriately assess risk. It is in these situations that commercial surety bonds play a vital, protective role.

## IMPORTANT USES FOR COMMERCIAL SURETY

Commercial surety bonds are an integral part of the regulatory scheme for many businesses, occupations and activities. State agencies value the surety’s prequalification in industries such as mortgage banking, real estate, health clubs and auto sales. Commercial surety bonds can be used in a variety of situations, especially in any industry that accepts money from consumers for services rendered later. Some of the most significant types of commercial surety bonds that protect consumers and enforce public policy are:

✓ **License and Permit Bonds:** State law, municipal ordinances or regulations require these bonds if a company seeks to obtain a license or permit. If

a principal violates its obligations, this bond pays the obligee (the government agency) or other third party (for example, defrauded consumers). Specific types of license and permit bonds include:

✓ **Money Transmitter Bonds:** A surety bond that guarantees money transmitters offer services in compliance with state regulations.

✓ **Mortgage Broker Bonds:** A bond required for a mortgage broker to be licensed in a state. The bond typically requires that the broker will conduct his or her professional activities in accordance with statutes and regulations. The bond is usually required by a regulatory agency, such as the Department of Insurance or Department of Finance.

✓ **Reclamation Bonds:** Required by a state regulatory agency, such as the Bureau of Land Management or Department of Environmental Quality, for a business that seeks to mine or perform related activities on public lands. These bonds provide a financial guarantee that the cleanup costs associated with mining will be covered and that the lands will be restored or reclaimed.

✓ **Subdivision Bonds:** Required by local development authorities that issue development permits. Developers are required to provide this bond if they are going to disturb a plot to sell lots or homes. They must provide a bond to guarantee their obligation to install improvements, such as water and utilities, and that the work is completed in compliance with state and local statutes and regulations.

## HOW COMMERCIAL SURETY WORKS

Like contract bonds, commercial surety bonds involve a third party (the surety) prequalifying a company during a rigorous underwriting process,

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RAY GRACE, COMMISSIONER OF BANKS, NORTH CAROLINA

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which involves a review of the credit history of the principal, the financials of the business, the company’s individual risk profile and the bonded obligation. With commercial surety bonds, the price is based on the dollar amount of the bond needed, the risk level associated with the industry, the term of the bond and the financial history of the person seeking the bond. Prices for these bonds typically range from 1 percent to 3 percent of the bonded obligation.

The company’s ability to qualify for these bonds indicates to the state or locality that it is capable of doing business and abiding by laws, and should be granted a permit or license. Commercial surety bonds, such as reclamation bonds, also define a company’s financial or performance obligation to a public entity.

A claim happens when the bond principal defaults or fails to perform on its obligation. Depending on the type of bond, not only can the obligee make a claim under the bond, but other intended beneficiaries can as well. For example, if a mortgage broker lied to a customer or was supposed to provide certain disclosures to the customer and did not, and that customer is harmed, not only can the department of financial services be a claimant on the mortgage broker bond, but that consumer also can make a claim.

Ray Grace, North Carolina’s Commissioner of Banks, says his state has various bonding requirements for mortgage licensing and money transmitters because it provides an additional layer of protection for the agency and consumers who use these services.

“We look at surety bonds, not just for quick and reliable payment in the event that the company

defaults on obligations or is unable to honor them, but we also look at them as an additional measure of due diligence that’s applied to these companies,” Grace says. “Surety bonds tend to be our quickest means of recourse and remedy in the case of a default by a company on its obligations. We can get that money to consumers quickly because a surety bond is written in our favor under the terms that we require.”<sup>24</sup>

As an example of the consumer protection value of commercial surety bonds, Grace points to the recent case of a money transmission company that went out of business, leaving a fair amount of money in transit, undelivered. Because of the surety bond, the agency was able “to assure that all the consumers in North Carolina were made whole,” Grace says.

Grace’s agency also tries to strike a balance between providing reasonable protection for consumers without creating unreasonable demands on companies that want to do business in North Carolina. The state revised bond requirements for its Money Transmitter Act, so these requirements are now directly correlated with transmission volume by licensee rather than the number of locations. Still, Grace says surety bonds help his agency and others assess risk more thoroughly.

“I’m a big fan of skin in the game in any fiduciary business or financial business,” he says. “They’re (surety companies) not going to agree to underwrite somebody without an appropriate level of due diligence.”

Commercial surety bonds not only protect consumers, but also workers. After more than 200 New York nail salons were found to be in violation



Whether it's nail salons, mortgage brokers or the money transmission industry, bonds are good public policy for state and local agencies. Whenever there is an obligation, there needs to be assurance that agencies can protect consumers and seek remedy for any malfeasance. Bonds give states and localities a pathway to achieve this aim.



of state labor laws due to horrible wages and working conditions, the state issued new wage bond requirements.<sup>25</sup> The bond requirements are based on the number of workers a salon owner employs and the number of hours of nail services provided by employees. The wage bond requirements range from \$25,000 for at least two full-time employees to \$125,000 for six or more employees.<sup>26</sup>

Alphonso David, counsel to Gov. Andrew Cuomo, says requiring salon owners to secure a wage bond ensures these businesses have the necessary funds to meet their financial obligations. The state hopes the new requirements will curb wage abuse in the industry.

"Egregious wage theft was rampant in the nail salon industry in New York State. This administration believes in the promise of a fair day's pay for a fair day's work, and the wage bond requirement

will ensure that nail salon workers are paid what they are legally owed," David says.<sup>27</sup>

"The requirement is an important part of the nail salon reforms that we enacted and has contributed to the 'historic shift' worker advocates say has occurred in the industry," he continues. "We've recovered millions of dollars in wages stolen from manicurists. For thousands of nail salon workers, the egregious wage theft and abuses that were common just a year ago are things of the past."

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