

Bonds

Surety Bonds:
An Integral Part of
Consumer Protection



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The Role of Surety Bonds in Consumer Protection

States require business entities and individuals to obtain a license or permit or register or obtain a certification from a regulatory agency to conduct a business or provide services in the state. These requirements largely are for consumer protection. Licenses, permits, registration and certification often are granted only after the business or individual posts a surety bond guaranteeing compliance with laws and regulations. In the surety industry, these bonds are referred to as “compliance bonds.”

The two primary purposes of these surety bond requirements are: 1) to prequalify the applicants who will comply with the statutory obligations, and in so doing, prevent losses; and 2) to provide some reimbursement for losses, up to the penal sum of the bond, if the applicant defaults on its obligations.

Surety companies check the credentials of applicants before they can do business to ensure that they are qualified. Sureties check on applicants’ experience, financial stability, and rely on local agents’ recommendations before issuing bonds. In issuing a surety bond, the surety provides the regulatory entity with pre-qualification of businesses or individuals who will perform as required, along with the added benefit of the bond amount being available for payments if the licensee fails to perform.

Under a typical surety bond, the surety guarantees to the Obligee (regulatory entity) that the Principal/Obligor (bond principal) will comply with all the laws and regulations applicable to the license, permit, registration, or certification. Surety bonds usually run concurrently with the term of the license, permit, registration or certification and any renewal of such periods. If the authorization from the state is revoked or suspended for any reason, the surety bond generally will become ineffective. Surety bonds usually run to the state for the benefit of any person injured by the wrongful acts of the bond principal. Generally, only the state can make a claim under the license bond, and the State can take the proceeds and use them as appropriate to remedy the consumer harm.

A surety bond also provides a strong incentive for a business or individual to comply with the terms of their authorization from the State because if there is a legitimate claim under a surety bond, the surety pays it, up to the penal sum of the bond, but the individual or business obtaining the bond must indemnify or repay the surety. The business or individual that does not perform as the state requires has its own assets at stake for the results of non-compliance.

The legislature or a regulatory entity sets the bond amount, which should provide a strong incentive for compliance, as well as have some correlation to the risk being underwritten. As the bond amount increases or the scope of the obligations under the surety bond expand, the surety tightens its underwriting parameters. If the statute requires an unduly high bond size, or results in unduly high aggregate liability related to the bond principal’s requirement to post bonds in multiple states, some bond principals may not be able to obtain the required surety bonds. For example, a surety

likely will require the bond principal to demonstrate that it has sufficient financial resources (net worth, working capital, liquid assets) relative to the bond amount. The higher the bond liability, the higher financial position will be required. If the bond amount is too high, some financially sound small businesses and individuals may find it hard to obtain the bond.

When state legislators require surety bonds, the state regulatory entity charged with administration and enforcement of the law frequently promulgates the bond form for the surety's guarantee of compliance.

For the protection of the public as well as the surety, the surety should be able to cancel the bonds required on reasonable notice to the state regulator. In this way, if the surety believes that the business or individual is violating the terms of its compliance, the surety can act to stop future violations, rather than having to wait until the bond expires or is up for renewal. This protects the surety by allowing it to stop further liability, but also protects the public by terminating the license if the surety detects violations of the law.

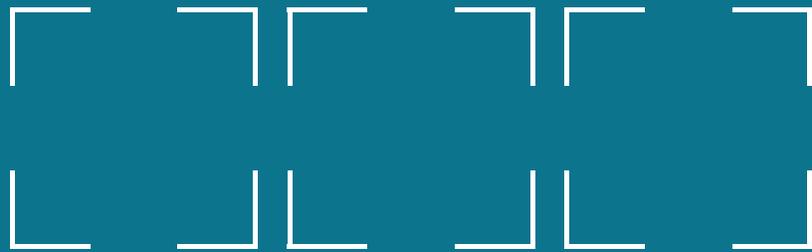
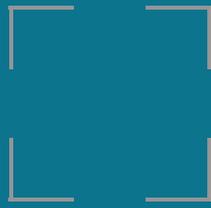
In addition, the bond form should explicitly state that the surety's aggregate liability is the penal sum of the bond. Such a provision avoids the misinterpretation that a separate bond limit applies to each claim or that the bond amount increases for each year the bond is in effect. A bond with such cumulative liability is not widely available as the surety cannot assess its maximum exposure under the bond.

Liability insurance is often confused with compliance bonds. Liability insurance offers significant protection, but it differs from bonds. Liability insurance protects the policyholder, not the consumer. If a policyholder is sued, for example, its liability coverage will provide defense costs and pay for any damage cause or liability imposed if the lawsuit is successful.

Public policy generally does not permit a person to insure against his own violations of law or regulation. A bond is needed to protect the public from this kind of violation, just as insurance is needed to protect against accidental acts or omissions. Surety bonds are an important consumer protection tool.

The Surety & Fidelity Association of America
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Surety and fidelity bonds: Protecting consumers, taxpayers and businesses.

