License Bonds
License Bonds — The Basics

A business takes few actions today without governmental permit or approval. Licenses and permits are granted every day to contractors, installers, peddlers, plumbers and a wide variety of service providers. Many of these government permits are granted only after the business posts a bond guaranteeing compliance with laws, ordinances and regulations. A license bond protects the consumers against a job that is faulty or substandard due to the actions of a license or permit holder.

The two primary purposes of a license bond are: 1) to prequalify the license applicants who will comply with the statutory obligations for a license, and in so doing, prevent losses; and 2) to provide some reimbursement for losses, up to the penal sum of the bond, if the licensee defaults on its obligations. Surety companies check the credentials of potential license holders 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.

With a license bond, the surety provides the regulatory entity with the pre-qualification of license applicants who will perform as required, and the added benefit of the bond amount being available for payments if the licensee fails to perform.

Under a typical license bond, the surety would guarantee to the Obligee (regulatory entity) that the Principal/Obligor (licensee) will comply with all the laws and regulations applicable to the license. License bonds usually run concurrently with the license period and any renewal of such periods. If the license or registration is revoked or suspended for any reason, the license bond generally will generally become ineffective as the license period will have ended. License bonds usually run to the State for the benefit of any person injured by the wrongful acts of the principal (licensee). 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 licensee to comply with the terms of their license because if there is a legitimate claim under a license bond, the surety pays it, up to the penal sum of the bond, but the licensee must indemnify or repay the surety. The licensee that does not perform as required has its own assets at stake for the results of non-compliance.

The bond amount 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 bond expand, however, 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 principal’s requirement to post bonds in multiple states, some principals may not be able to obtain the required bonds. For example, a surety likely will require the 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 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 advance notice to the state regulator. In this way, if the surety believes that the provider is violating the terms of its licensure, 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.

License and permit bonds are divided into five classes:

- Bonds designed to protect the health and safety of the public, e.g., home service contractor or sewer builder.
- Bonds required of an individual who has been granted some public privileges which may become a hazard to the general public, e.g., hanging a sign over a street.
- Bonds which protect the public against loss of money or goods entrusted to the licensee, e.g., real estate broker, public warehouseman, etc.
- Bonds required of businesses highly susceptible to unscrupulous practices, e.g., small loan companies, motor vehicle dealers.
- Bonds which guarantee payment of taxes collected, e.g., gasoline tax bonds, sales tax bonds.

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. If a licensee leaves town without correcting their code violations, the bond will pay. License and permit bonds are an important consumer protection tool.
Surety and fidelity bonds: Protecting consumers, taxpayers and businesses.