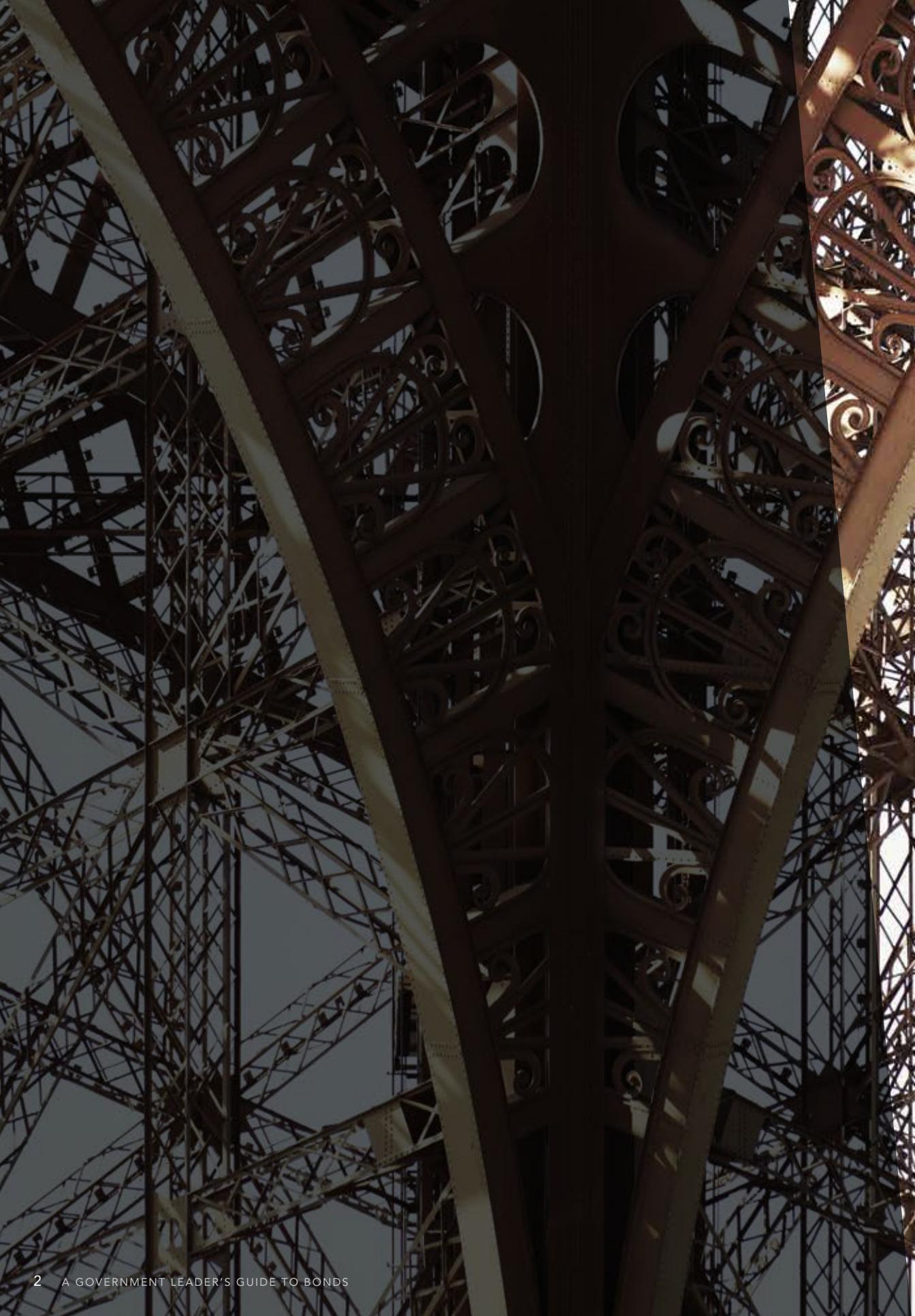




# A GOVERNMENT LEADER'S GUIDE TO BONDS

USING SURETY AND  
FIDELITY BONDS TO  
PROTECT TAXPAYERS,  
EMPOWER BUSINESSES  
AND ENABLE INNOVATION





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## INTRODUCTION

# A CAUTIONARY TALE: WHEN AN INFRASTRUCTURE PROJECT GOES BAD

### IN 2004, HARRISBURG — PENNSYLVANIA'S CAPITAL CITY—

experienced a conundrum. Faced with more stringent federal emission standards and regular financial losses, the city was considering what to do with an old waste-to-energy resource recovery facility that converted garbage into electricity.

The plant, which opened in 1972, never fully materialized into the moneymaking enterprise the city had hoped for and officials had to decide between closing or selling the facility — on which it still owed \$104 million — or retrofitting and expanding it to generate new revenue and meet U.S. Environmental Protection Agency (EPA) standards.

Harrisburg went with the second option and hired Colorado contractor Barlow Projects to upgrade the facility for \$77 million. The deal was attractive to the city because Barlow's bid was \$40 million less than anyone else. The company also had developed patented technology that seemed tailor-made for the project.

Unfortunately, there were several red flags the city either missed or chose to ignore. Barlow had never completed a project on the scale of Harrisburg's. It also didn't qualify to be bonded, a measure that most municipalities require to protect themselves in the event a contractor defaults and can't complete the contract.

From the start, Barlow struggled to manage the project and the subcontractors

it hired. Though the city enacted several measures to protect itself, including fining Barlow for failing to meet deadlines and withholding a percentage of the company's payments until the project was completed, it ultimately didn't require Barlow to have the one thing necessary to fully protect taxpayer dollars: a performance bond.

The Harrisburg City Council eventually fired Barlow and hired a new contractor, but had to pay them an additional \$25 million to finish the project.<sup>1</sup> The debacle led to several years of political and financial chaos, including the mayor's ouster, the city trying to declare bankruptcy but going into receivership, and the sale of the plant to pay the city's guarantors.<sup>2</sup>

Harrisburg had to pay Lancaster County, one of its guarantors, \$6.65 million per year for the next 20 years in disposal fees, and had to privatize lucrative city parking garages in a long-term lease, leading to layoffs for city employees, loss of parking revenue for the city and increased parking fees that hurt downtown businesses. The city increased taxes and fees and requested that police, firefighters and other municipal employees forgo salary increases and contribute to their own health care insurance.

Harrisburg is a cautionary tale, but it also clearly illustrates why bonding should be non-negotiable.



## PROTECTION AND PREQUALIFICATION: THE POWER OF SURETY BONDS

A bond is a type of insurance, issued by insurance companies called sureties, that serve as a risk mitigation tool for states and localities. They have two key benefits: protection and prequalification. Bonds come in all forms, but three types of bonds are particularly relevant to government agencies and policymakers: contract surety bonds, commercial surety bonds and fidelity bonds. Contract surety bonds, which include performance and payment bonds, help provide assurance to the public, subcontractors and suppliers that companies and individuals will meet their performance and financial obligations when they undertake a project, and that taxpayers and consumers aren't on the hook financially in the event they fail to do so. Commercial surety bonds are required by state regulatory agencies before a company can be licensed or permitted to do business in an industry, providing additional consumer protection. Fidelity bonds protect businesses from losses caused by employee misconduct, fraud, dishonesty or cybercrimes that may be committed against them. They can also provide the business with a source of funds to remedy harm to consumers caused by a dishonest employee.

Contract, commercial and fidelity bonds each serve a critical risk management and public policy function. This handbook provides an overview of each of these products, explains why bonding should be non-negotiable for agencies hiring contractors and for businesses operating

within a state or local jurisdiction, and addresses how agencies can better protect taxpayer dollars and strengthen the public procurement process.

### LICENSED SURETY COMPANIES

Surety bond requirements should state that the bond must be furnished by an insurance company authorized to write surety bonds by the applicable state insurance department. This requirement is good public policy. Surety is a form of insurance, so it makes sense that bonds be written by insurance companies. This ensures the entity providing the bond is solvent, responsible and will be available to pay claims.

The state insurance department usually has the most information about the surety, as it is responsible for performing periodic examinations of the company. When taking a bond from a particular surety, it is prudent to confirm with the insurance department that the surety is licensed. The state has a strong interest in regulating and imposing certain minimum capital and financial reporting requirements on those who conduct surety business in the state to protect the state's resources, citizens and the businesses which are beneficiaries of surety bonds.

There have been significant abuses and fraud in the past when unregulated or unlicensed sureties were permitted to issue bonds. With no oversight, there is no assurance the assets backing the bond are real. If the assets pledged to support the bonds are of little or no value, public agencies and taxpayers are left with no viable protection in the event of a default.

# CONTRACT SURETY BONDS: A MUST FOR PUBLIC WORKS PROJECTS

## CONTRACTING IS RISKY AND SOMETIMES CONTRACTORS DEFAULT.

Research conducted between 2013 and 2015 found that contractors have a failure rate of approximately 29 percent,<sup>3</sup> meaning that 1 in 4 of these businesses will fail, leaving unfinished small- and large-scale construction contracts in their wake.

You can find stories of contractor default across the nation. In North Carolina, a contractor defaulted on a \$15.9 million infrastructure contract, leaving 4 N.C. Department of Transportation projects halfway complete.<sup>4</sup> In late 2015, the Central Texas Regional Mobility Authority notified its contractor — which won a \$136 million contract to add toll lanes to an 11.2-mile stretch of highway in Austin — that it was in default. The project experienced significant delays and was three months past its intended completion date.<sup>5</sup>

In cases like these, contract surety can shield states or localities from risk. It's a best practice for government agencies no matter what their procurement process entails.

Just ask John Obr, former director of the Construction Division for the Texas Department of Transportation (TxDOT). The division oversees construction contracts for the massive agency, and Obr spent much of his four years as director helping to resolve contractual issues. According to Obr, bonding requirements for contractors undertaking major construction projects are a valuable tool for safeguarding the agency and

Texas taxpayers. "The bond process gave me peace of mind by ensuring we were protected should serious problems occur," he says.<sup>6</sup>

That protection proved invaluable several years ago when a TxDOT contractor with more than a dozen active projects worth over \$300 million declared bankruptcy. "We brought in the surety and started discussing how to get each project back under construction as quickly as possible," Obr says. "They hired an engineer of their own to run the operation, and they worked with us to prioritize project completion because you can't just take that number of projects directly to construction."

The surety assembled bid packages for each project, awarded new contracts and worked through any outstanding issues that could jeopardize completion. "They did all the work that we would have to do if we didn't have the performance bond," says Obr, who is now a consultant for a private construction firm. "Everything got back under construction, and we got them all done."

Bonds also protect agencies via a thorough underwriting process that prequalifies contractors an agency is considering hiring — potentially weeding out unqualified companies from the bidding process. Bonds also allow states and localities to undertake more innovative procurement methods, like public-private partnerships (P3s), because a

## HOW ARE CONTRACT BONDS PRICED?

Bonding typically costs 1 percent of the contract amount or cost of the project. The cost of a performance bond, for example, is a one-time premium between 0.5 percent and 3 percent of the contract amount. The rates must be filed with state insurance departments and many companies reduce the premium amount for well-established, experienced and financially strong firms. Though premiums may be higher for newer or less capitalized firms, sustainable small businesses with an established track record also can get lower rates. The premium is paid by the project owner, typically in the first pay request.

Bid bonds typically don't come with a fee. Payment bonds are usually issued in conjunction with performance bonds for no additional charge, and many sureties offer 100-percent coverage for both.<sup>7</sup> For example, if the contract amount is \$10 million, a premium of between \$57,000 and \$81,000 could pay for a performance bond and payment bond that provide protection of \$20 million.



third-party — the surety company — provides critical security if something goes wrong.

Generally, there are three types of bonds that fall under the contract surety umbrella:

✓ **Bid Bonds:** These bonds ensure that a bidder for a supply or construction contract will enter into the contract within the stipulated timeframe if the company wins the bid. Bid bonds also ensure the bidder will provide proof of a performance or payment bond, which transfers the financial risk to a third party if the work isn't completed.

✓ **Performance Bonds:** A bond that guarantees performance of the terms of a written contract.

✓ **Payment Bonds:** A bond given by a contractor to guarantee payment to subcontractors, laborers and suppliers for work performed under the contract.

## HOW CONTRACT SURETY WORKS

The majority of states require a contractor to furnish bid, performance and payment bonds, with the latter two required for 100 percent of the contract amount. However, every state also can set its own bid bonding requirements, which are typically a percentage of the contract price, depending on the project. For example, in California, a bid for any public project must include either a bid security payable by check or cash, or a bid bond issued by a surety equal to 10 percent of the bid amount.<sup>8</sup>

At the federal level, the Miller Act — which was established in 1935 to replace the original law, the Heard Act — requires payment and performance bonds for federal construction projects over a certain statutory threshold.

If a bond is required for a public infrastructure project, a contractor must acquire it from a surety company. Surety companies determine whether a contractor is bondable by using an underwriting process that evaluates whether the contractor has the capacity, capital and character to undertake the project.

## FOR THE RECORD: WHAT YOU NEED TO KNOW ABOUT CONTRACT SURETY BONDS

**Sureties pay billions of dollars a year in claims.** Over the last 15 years, surety companies paid nearly \$12 billion to complete construction contracts and pay subcontractors and suppliers what they were owed. These numbers do not include the significant amount of money sureties spent to finance troubled contractors so they could complete contracts and protect the government from a default.

### Other important facts:

**Sureties provide an independent third party opinion that a contractor is qualified to perform.** Sureties are in a unique position to prequalify contractors as they have access to confidential information typically unavailable to a project owner.

**Waiving bonds hurts small and minority contractors.** If bonds are waived, the small contractor may never receive his or her business review from a surety and will not have the opportunity to build a successful track record with the surety company.

### Raising bond thresholds exposes small and minority contractors to loss.

Raising bond thresholds increases the risk of non-payment and contractor default due to the lack of a surety's extensive prequalification process. Failure to get paid can be catastrophic to small contractors.

### No other product provides the same protection as bonds.

No other risk management product provides the comprehensive protection that bonds provide, which is to guarantee that a construction contract will be completed and workers on the job will be paid.

**For more information and common misconceptions about bonds, visit:**  
<http://c.ycdn.com/sites/www.surety.org/resource/resmgr/LearnAboutSurety/CommonMisconceptions.pdf>

During the underwriting process, a surety company will review a contractor's financials, cash flow, tax returns, liquidity and debts, and ask for letters of recommendation and references. Through this process the surety company is vetting the contractor. When a surety company issues a bond to a contractor, this signals to a government agency that the contractor is competent and qualified to do the work — and that the risk of the contractor defaulting is low. However, if a default does occur, the surety company assumes the responsibility of completing the contract.

### UNIQUE BENEFITS OF CONTRACT BONDS

It's important to understand that the goal of bonding is to provide security that the contract will be performed fully, protecting taxpayers from footing the bill on a defaulted project. In 2015 alone, surety companies paid \$1.1 billion on contract surety bonds. It's in the best interest of the surety company to ensure a contractor can fulfill the obligation. But if it can't, depending on the terms of the performance bond, the surety can offer several remedies. For example, it can:

- ✓ Take over the contract and hire a replacement contractor.
- ✓ Re-bid the contract and tender the new contractor to the obligee (the government agency).
- ✓ Give the existing contractor technical or financial support.
- ✓ Pay the full amount of the bond to the obligee.

### THE IMPORTANCE OF BOND FORMS

Each obligee (or state agency) will have its own bond form. Balanced bond form provisions ensure protection to the obligee and maximum availability to all contractors. The most commonly accepted bond forms are provided by the American Institute of Architects, Design-Build Institute of America and a few other well-known organizations in the industry. Here are some key resources:

- ✓ [www.aiacontracts.org](http://www.aiacontracts.org)
- ✓ [www.dbia.org](http://www.dbia.org)
- ✓ [www.consensusdocs.org](http://www.consensusdocs.org)
- ✓ [www.ejcdc.org](http://www.ejcdc.org)

Remedies for the obligee are contained in standard bond forms. See the sidebar, "The Importance of Bond Forms," at the bottom of this page for additional information.

Compared to other risk mitigation tools, bonds provide a unique set of benefits. A letter of credit, for example, may provide financial compensation to a state or local government if a contractor defaults, but it almost never accounts for 100 percent of the project costs. The biggest issue with using letters of credit or similar tools is that no one is responsible for completing the contract — or paying subcontractors and workers — in the case of a default. By contrast, sureties enable the hiring of replacement contractors or re-bidding of the contract, and assume responsibility to save many projects.

In 2006, a local turnpike commission declared a well-known contractor in default on a \$16 million highway project. The work was only 65 percent complete, but a surety stepped in and awarded the contract to another contractor who was already on the job, completing it on time.<sup>9</sup> You don't get this kind of guarantee with a bank.

The payment bond guarantees that covered subcontractors, suppliers and laborers on the job will get paid. A payment bond often is the subcontractor's and supplier's sole recourse for non-payment on public projects. A mechanic's lien generally cannot be asserted against public property, and subcontractors and suppliers usually look to the payment bond for financial protection. Without a payment bond, a subcontractor has no remedy. Subcontractors cannot make a claim on a letter of credit. Requiring payment bonds is sound public policy for the protection of subcontractors and suppliers, which are often small businesses.

According to a recent Governing Institute survey, nearly 7 in 10 state and local government decision-makers categorized infrastructure modernization as urgent.<sup>10</sup> However, there's limited public funding available for these projects. Bonding allows states and localities to undertake innovative procurement methods, like P3s, because the surety company provides critical security if something goes wrong. States also can spread out the cost of these projects over a much longer time period, which eases budgetary constraints.<sup>11</sup>

Bonding also minimizes risk while promoting and elevating sustainable businesses. Legislators often hear constituents' concerns about their

## A BETTER ASSESSMENT OF RISK

In a 2016 Governing Institute survey, state and local government officials acknowledged they could use help evaluating the capabilities of potential contractors. About half of the 126 respondents said their jurisdictions were only somewhat effective in assessing their risk for large projects.<sup>12</sup> This indicates that states can benefit from the risk mitigation services surety companies provide through bonding. Surety companies underwrite 100 percent of the risk for qualified contractors, offering value from a prequalification and claims standpoint. By waiving bonds, states are waiving away their protection and transferring the accountability from contractors to themselves — and ultimately to taxpayers.

inability to obtain bonding. However, the underlying intention with bonding is not to exclude businesses from the process, but to help public agencies assess their risk and empower contractors to undertake construction work they can deliver. Sureties don't create a barrier to entry for different businesses to bid on or get public sector construction work, but they do ensure the integrity of the process.

Clarence McAllister, a licensed professional engineer, CEO of Fortis Networks and an MBE, DBE and HUBZone contractor who has worked on many local, state and federal contracts, says bonding has helped his company grow over the last 16 years.<sup>13</sup> Fortis was accepted into the 8(a) Business Development Program, a federal program that helps small businesses enter the government contracting field and compete for these contracts. As part of 8(a), owners have limits on the amount of money they can take from their company based on its revenue, building their business' net worth and making it more financially solvent and sustainable. This allowed Fortis to qualify for and steadily grow its bonding.

"We had to learn to crawl before we could walk and then run," McAllister says. "Today our largest bond is \$10 million, but it took time to show we are able to perform and show that we make profits on those larger jobs before we're able to go to the next level." McAllister now has capacity of \$20 million for a single bond and \$75 million for his total program.

As McAllister's company illustrates, bonding is an empowerment tool, especially for small businesses. Programs like 8(a) and the Model Contractor Development Program — which help local surety associations develop initiatives, educational outreach and support programs for women, minorities and small business contractors — prepare contractors to achieve bonding,

allowing these companies to gradually build their business and progressively move from smaller to larger contracts. Ultimately, the work surety companies do helps qualified contractors get into the game, while also ensuring municipalities have a strong pipeline of companies that can meet their infrastructure needs.

## BONDING EDUCATION AND EMPOWERMENT

Many public officials focus on community and support inclusion of small, emerging and minority contractors in their procurement process with a goal of expanding the pool of contractors who can successfully participate in public works projects. Often contractors do not know where to go or what they need to do to access the world of surety bonds.

The Model Contractor Development Program<sup>®</sup> was developed by the Surety & Fidelity Association of America (SFAA) to educate contractors so they learn what they need to do to grow sustainable, healthy and profitable businesses, and obtain surety bonds. One of the most successful adaptations of the MCDP<sup>®</sup> is the U.S. Department of Transportation Bonding Education Program (BEP) in partnership with SFAA. Since its inception in 2010, the BEP has educated contractors on what they need to know and the steps they need to take to build strong businesses that are bondable, resulting in more than 70 BEPs and more than \$600 million in initial bonding capacity. The one-on-one consultations and prescriptive plans prepared for each contractor provide the "secret sauce" for success.

For more information about the BEP, visit [www.transportation.gov/osdbu/financial-assistance/bonding-education/bonding-education-program](http://www.transportation.gov/osdbu/financial-assistance/bonding-education/bonding-education-program). For information on MCDP<sup>®</sup>, visit [www.surety.org/?page=MCDP](http://www.surety.org/?page=MCDP).



# 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,

**“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.”**

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."

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.

# FIDELITY BONDS: PROTECTING BUSINESSES AND AGAINST EMPLOYEE MISCONDUCT & CYBERCRIMES

**GOVERNMENTS AND BUSINESSES SEEK FIDELITY BONDS TO PROTECT THEMSELVES FROM LOSS DUE TO EMPLOYEE DISHONESTY OR MISCONDUCT.**

In addition to directly protecting governments and businesses, fidelity bonds provide indirect consumer protection because governments may regulate certain businesses that handle consumer funds. In these cases, government agencies have a vested interest in protecting these funds. Requiring a business to get a fidelity bond provides this safeguard, even though a government entity can't make a claim directly against the fidelity policy. However, it does ensure that if a business is defrauded, the business has the proper insurance to recoup its losses and redistribute them to any customers who also have been deceived. In this sense, fidelity bonds are another regulatory tool that state agencies can leverage to keep businesses honest and serve as a last line of defense for consumers.

One of the most significant perils for businesses is employee dishonesty, and unfortunately there have been several examples of this in recent decades. The case of commodities trader Evan Dooley is one of them. Dooley worked for MF Global, a financial firm based in New York. One night Dooley made large trades on wheat contracts on the Chicago Mercantile Exchange's (CME) overnight electronic exchange. The trades exceeded his allowable margin, potentially leading to losses Dooley knew he couldn't cover.

That's exactly what happened when the market opened the next day, leading to a \$141 million loss for MF Global, which was legally responsible to cover it as a clearinghouse member of CME. Dooley was later sentenced to five years in prison for exceeding speculative position limits under the Commodity Exchange Act.<sup>28</sup>

More than \$100 million is significant, even for a firm that manages more than \$42 billion in assets.<sup>29</sup> But MF Global could afford to cover the loss because it had additional protection in the form of a fidelity bond. The bond covered the loss and the company was paid.<sup>30</sup>

Fidelity bond claims also have occurred in other industries. A Louisiana bank executive, Jim Scott, was recently sentenced to 42 months in jail after it was discovered he embezzled \$1.7 million from his employer of 14 years, Tri-State Bank and Trust. Scott moved money from the bank's general fund into his own personal account at the same bank.<sup>31</sup> However, because Tri-State Bank and Trust had a fidelity bond through its insurer, the loss was covered.<sup>32</sup>

Sometimes employee fraud occurs in places you wouldn't expect. A prime case of this is an accounting clerk for a local charity who created fake invoices for fake vendors and opened corresponding bank accounts in these names to collect the payments. A personal audit led to a

**A FIDELITY BOND DIFFERS FROM CONTRACT AND COMMERCIAL SURETY BONDS IN CERTAIN RESPECTS, INCLUDING THAT IT'S A TWO-PARTY, RATHER THAN THREE-PARTY, AGREEMENT. ALSO, UNLIKE SURETY BONDS, IT'S THE INSURED PURCHASING THE BOND OR THE POLICY, AND IT'S THE INSURED WHO ACTUALLY BENEFITS OR MAKES A CLAIM UNDER THE POLICY.**

# CONSUMERS

ACCORDING TO THE ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, EMPLOYEE FRAUD AND ABUSE COSTS THE AVERAGE ORGANIZATION 5 PERCENT OF ITS REVENUES EVERY YEAR, AMOUNTING TO A FRAUD LOSS OF ALMOST \$3.7 TRILLION FOR BUSINESSES WORLDWIDE.

confession of his crimes. The loss totaled more than \$2 million, but the charity fortunately had enough fidelity bond coverage to account for the employee's misconduct.<sup>33</sup>

These situations happen with shocking regularity. According to the Association of Certified Fraud Examiners, employee fraud and abuse costs the average organization 5 percent of its revenues every year, amounting to a fraud loss of almost \$3.7 trillion for businesses worldwide.<sup>34</sup>

But a fidelity bond protects businesses from these abuses. For example, an executive vice president with complete funding authority at a rural bank created a pyramid of fraudulent auto dealership loans for untrustworthy customers, creating a \$2.3 million write-off for the bank for bad loans.<sup>35</sup> In another case, a former president of a bricklayers' union embezzled more than \$250,000, causing the office to move into receivership.<sup>36</sup> A fidelity bond could have helped in both of these cases.

## HOW FIDELITY BONDS WORK

A fidelity bond is more akin to what you would think of as traditional insurance. It's a two-party agreement between the insurer and the insured. The theft or dishonesty of an insured's employee(s) is the peril and what triggers a claim. Typically, the

insured is a business. If a business has employees, one of its risks is that employees may steal from it. To protect against this risk — however unlikely it may seem — a company will obtain a fidelity bond.

A fidelity bond differs from contract and commercial surety bonds in certain respects, including that it's a two-party, rather than three-party, agreement. Also, unlike surety bonds, it's the insured purchasing the bond or the policy, and it's the insured who actually benefits or makes a claim under the policy.

With a fidelity bond, the insured must incur the loss. There's a deductible, as well as terms and conditions. This type of bond has other coverages, including burglary, theft and various cybercrimes. Fidelity bonds also have evolved to cover social engineering schemes, where a cyber thief will send an employee an email pretending to be an executive or other representative of the company to induce that employee to transfer funds. A variety of industries and entities are required to obtain fidelity bonds pursuant to statutes and regulations as another way of protecting the consumer, including:

- ✓ **Homeowner Associations (HOA):** In this instance, an HOA would get a fidelity bond to cover anyone who has access to or control over the association's funds.
- ✓ **Banks and Credit Unions:** In some states, these entities must acquire bonds to cover



Though fidelity bonds are not directly connected to public policy, they can have implications at the state and local level. Government agencies have a vested interest in protecting consumers from fraud, especially in industries that handle consumer funds and are regulated by the government.

potential fraud or dishonesty of their treasurers, employees, directors or other agents affiliated with the financial institution. Bond coverage is required for federally insured, state-chartered banks and credit unions.<sup>37</sup>

✓ **Public Officials:** A bond that guarantees the faithful performance of duty of a public official and ensures this person honestly handles all public funds. This bond is given to comply with a statute and covers whatever liability the statute imposes.

Some of the most well-known examples of fidelity bonds are ERISA bonds, or those required by the Employee Retirement Income Security Act. ERISA requires handlers of Welfare Plan Funds to be bonded. The plan meets this requirement by obtaining a fidelity policy where the plan is the named insured. This covers the dishonesty of those who handle the plan funds.

Some states have fidelity bond requirements for specific industries. For example, in 2013 Florida enacted legislation that required a fidelity bond for HOAs. The law requires

these associations to have enough bond coverage to cover the maximum amount of money under the HOA's management at any one time. However, there's also a loophole: An HOA can waive bonding by a majority vote.<sup>38</sup> In Maryland, title insurance agencies are required to have a fidelity bond because they handle customer funds during a real estate closing, a responsibility that could provide opportunities for employee misconduct or abuse. In 2015, Wyoming also enacted a law that requires at least \$1 million of fidelity bond coverage for chartered family trust companies. The bond indemnifies these companies against a loss resulting from criminal or fraudulent activities by employees, active officers, managers or members acting in a managerial capacity.<sup>39</sup>

Though fidelity bonds are not always directly connected to public policy, they can have implications at the state and local level. Government agencies have a vested interest in protecting consumers from fraud, especially in industries that handle consumer funds and are regulated by the government.



## CONCLUSION

# MITIGATING RISK AND ENABLING PROGRESS

### CONTRACT SURETY, COMMERCIAL SURETY AND FIDELITY BONDS PROVIDE PROTECTION FOR GOVERNMENT ENTITIES, BUSINESSES AND CONSUMERS.

With contract bonds, surety companies put contractors through an intensive underwriting process that prequalifies these businesses to bid for public infrastructure contracts. This thorough vetting helps government agencies make the right decisions about whom they award contracts to, and at the very least, gives them a contingency plan should these hires default. For businesses, securing a bond opens the door to new opportunities by vouching for their ability to successfully complete projects. A 2016 Governing Institute survey found that many public officials deem infrastructure modernization urgent and that 56 percent of them are interested in non-traditional partnerships in government contracting. Sureties enable public agencies to engage in innovative procurement methods of this nature, such as P3s, allowing them to take on more risk while protecting taxpayer dollars.

Commercial sureties also provide protection for communities and taxpayers when they are a condition of licensing and permitting. What's happening in Wyoming is a perfect example of why bonds are necessary. If self-bonding wasn't in place, and real surety bonds had been required, the state could recoup more than just 15 percent

of the cost to reclaim land, but now it's left in legal limbo wondering when, and if, these mining companies will incur the multimillion dollar cost of reclamation or whether taxpayers ultimately will be on the hook for this obligation. Third-party bonding requirements could have avoided this situation.

Fidelity bonds, which are often required by law, are a tool that businesses and governments must seek for their own protection. As technology has evolved, it also has facilitated more crimes — from social engineering to hacking and various other forms of cybertheft — that put businesses in greater peril. If a business isn't in a position to protect itself from these losses, then it also isn't capable of protecting clients who entrust it with their assets and hard-earned money. Fidelity bonds allow public agencies to facilitate a level of indirect consumer protection that may not otherwise be possible.

There are a variety of insurance products on the market. A homeowner would be foolish to go without homeowner's insurance; a driver of a new car would be irresponsible not to carry full coverage; and people who live in a flood zone would likely render themselves homeless or bankrupt if they didn't have a flood policy. Bonding follows the same principle. It's insurance and protection that government entities and businesses shouldn't bypass — the potential consequences are just too great to shirk this responsibility.

# GLOSSARY OF KEY TERMS

**Bid Bond:** A type of contract surety bond that ensures a bidder for a supply or construction contract will enter into the contract within the stipulated timeframe if the company wins the bid. Default results in the obligee (a government agency, in this case) receiving the difference between the amount of the principal's bid and the bid of the next low bidder or company who qualifies for the contract, or the amount of the bond.

**Commercial Surety:** A type of surety bond that can be required by state and local regulators in a wide variety of situations to protect consumers and taxpayers. Some of the most significant for government policymakers include: license and permit bonds, reclamation bonds, mortgage broker bonds and subdivision bonds.

**Contract Surety:** Surety bonds that involve construction projects. In the event a contractor defaults, contract surety bonds ensure funds are available to complete the contract and pay subcontractors, suppliers and laborers.

**Fidelity Bond:** A bond a business seeks to protect itself in the event of a loss incurred because of employee dishonesty or misconduct. Some states require these bonds for businesses, such as title insurance companies and credit unions, that do business with consumers.

**License and Permit Bonds:** Statutes and regulations require these bonds if a company seeks to obtain a license or permit in a state or local jurisdiction. If a principal violates its obligations, this bond pays the obligee or other third party.

**Miller Act:** Law passed in 1935 that requires performance and payment bonds for federal construction projects over a designated amount, currently for contracts over \$150,000.

**Money Transmitter Bond:** A surety bond that guarantees money transmission companies offer services in compliance with state or local statutes and regulations.

**Mortgage Bond:** A type of commercial surety required by a state or local regulatory agency for mortgage brokers to become licensed in that state.

**Obligee:** The entity that requires the bond and is protected if there is a loss or default.

**Payment Bond:** A bond given by a contractor to guarantee payment to subcontractors, laborers and suppliers for work performed under the contract.

**Performance Bond:** A bond that guarantees performance of the terms of a written contract.

**Premium:** Required by a surety company from the principal for the issuance of a bond. Performance and payment bonds come with a one-time premium that typically equals up to 2 percent of the contract price.

**Principal:** Also called "obligor." This is the party who seeks the bond and is bound by the underlying obligation.

**Reclamation Bond:** Required by a state regulatory agency, such as the Department

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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 public lands mined will be restored.

**Subcontractor Bond:** A bond that a general contractor may require of a subcontractor, which guarantees the subcontractor will perform work in accordance with the terms of the contract and will pay for certain labor and materials under the contract.

**Subdivision Bond:** Developers must get this bond from a surety if they plan to develop a plot in a municipality to sell lots or homes. Local development authorities require these bonds, which guarantee a developer's obligation that the project will adhere to state and local statutes and regulations, before they issue a development permit.

**Surety:** Third party that issues the bond to the principal and is responsible for fulfilling the claim in the event of a default or loss.

**Surety Bonds:** A written agreement where a surety obligates itself to a second party, called the obligee, to answer for the default of the principal. In the case of public works contracts, the obligee would be the state agency and the principal would be the contractor.

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