

RISK MANAGEMENT

Bonding Your Business

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Risk Management: Bonding Your Business

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A bond is similar to insurance: the bonding company provides compensation if certain events covered by the bond occur. In fact, most bonds are written by specialized subsidiaries of the same companies that write business insurance policies. Since a bond fills a different need than an insurance policy, it's important to know when and if a bond is right for you. This article will help you identify situations when this form of protection is needed.

Bonding developed from the ancient practice of one party guaranteeing another's obligation. The bond is the surety company's guarantee to someone that they will not be harmed by another's failure to do as he had promised.

If you want to bond an employee, the surety company guarantees that you will not suffer loss if that employee steals from you. If a government agency requires that you present a bond if awarded a contract, this is the surety company's guarantee to the agency that you will perform as expected. Note that in this case, you are not a party to the two-way agreement between the agency and the bonding company. But, of course, they would not issue the bond for you unless an offsetting agreement existed between you and the surety.

Let's see how bonding could apply to the situations your business might face.

Fidelity Bonds

You've heard of bonding employees, for example. When you bond one or more employees, you are taking out protection in case they steal property such as: money, securities, parts, tools, equipment that belong to the company. Employees handling the company's books and records are sometimes bonded where there might be a risk of embezzlement. If such dishonesty were to occur, you would be compensated for the loss under the bond. This is called employee dishonesty insurance.

Why not use insurance instead of a bond? Because only bonding companies will undertake the extensive investigation necessary to properly evaluate the risk. While no guarantee of

honesty, you do have the comfort of knowing that your employees have nothing in their histories

that would make them more than normal risks to you (the obligee) if XYZ (you, the principal) does not faithfully fulfill his/her/their obligations to you.

The most frequent use of contract bonds is in connection with bids submitted to government agencies and the resulting supply or construction contracts. In this usage, a contract bond guarantees that you will do what you are supposed to do, as specified in the contract you will sign with the agency.

If you don't, the surety company usually does two things. First, it sees that the contract is completed either by getting an outside party involved to take over where you left off or by paying an amount agreed upon by all concerned to recompense the agency for the unfilled contract. Secondly, the surety company will come after you for reimbursement of its costs in making good on its bond.

The surety company is not in the supply or construction business. The last thing they want is to have to complete a contract. So they will look you over very carefully before committing themselves. Some of the factors surety companies will examine include track record, reputation, financial condition, expertise and experience, and strength to weather setbacks and still perform as contracted. They will measure you against the size and difficulty of the contract you want to enter into with the agency. Two key points are the conditions governing release of the bond and when this can take place.

In many cases, the surety company will insist on collateral to back up the risk of "going bond" for you. At first glance, it might seem preferable to deposit the collateral directly with the agency instead of paying for a bond. After all, if your liquid assets are going to be immobilized for this purpose, why pay the surety company's fee?

One answer to this, particularly in the case of construction contracts, is that government agencies, and indeed all owners, can't resist trying to find a way to keep your collateral for example; by calling your work incomplete or faulty or charging you with not meeting the requirements of the contract. Your collateral will be taken as liquidated damages and fighting this in court can be expensive.

Second, if you are going to be bidding regularly for such contracts, you need to establish your "bondability." Once you do, you will not be asked to put up collateral except in special circumstances.

Other Types of Bonds

In addition to the contract or performance bond discussed above, bidders have to submit a bond with their bids. The purpose of a bid bond is to make sure that you accept the contract if you are the successful bidder. This kind of bond is issued for a specified amount of money, usually 10 percent of contract value. This is paid to the beneficiary if you do not accept the award.

Another kind of bond that small firms are frequently required to put up covers the issuance of state and local licenses to do certain kinds of business. Again, if you do not abide by the requirements of the license, the bonding company pays the amount specified and comes after you for reimbursement. A variation of this kind of bond is sometimes required for businesses that collect certain kinds of taxes as agents for the state or locality. These bonds guarantee that you will pay over to them what you collect.

Conclusion

Obtaining a contract bond is difficult for the small or beginning entrepreneur. The U.S. Small Business Administration has a program to help beginning entrepreneurs obtain bonds for construction contracts. It works as a guarantee. The SBA will guarantee a surety company if you can satisfy their requirements. Even though collateral is usually required, at least at first, it need not be cash or securities.

A qualified insurance agent working with you, your accountant and attorney can help you decide when bonding is the best type of protection for your needs. As you have guessed by now, bonding is a highly complex field. The agent that you choose to help with your bonding requirements must be a specialist. If your regular insurance agent is not qualified (you should ask the agent bluntly about this) they will be able to recommend someone to you.

Finally, obtaining a bond can take time, especially the first time. The bonding company has a great deal of work to do checking and cross-checking all factors in the situation. Give your agent and the bonding company plenty of advance warning when it appears you will need a bond.