

SURETY BOND OVERVIEW

By [Christopher S. Pobiegló](#)

Unlike traditional insurance, surety bonds are a three party agreement that involve one party (**surety company**) making a financial guarantee on behalf of another party (**principal**), for the benefit and protection of a third party (**obligee**). The use of such surety bonds has been around since biblical days and has been a prominent part of business in the United States for more than 100 years.

There are two basic types of surety bonds:

1. Commercial surety bonds
2. Contract surety bonds.

Commercial surety bonds generally consist of license/permit bonds, financial guarantee bonds, court bonds, fidelity/fiduciary bonds and miscellaneous bonds. Contract surety bonds include bid bonds, payment bonds and performance bonds.

Commercial surety bond requirements vary from state to state and city to city, so it's important to know what bonding requirements you will have to comply with as a business owner. In the State of Alaska, a number of professions require licensees to either post cash or a surety bond as part of the licensing process. These include construction contractors, licensed secondary education schools, mortgage brokers, home inspectors, gaming operators, concert promoters, and motor vehicle dealers. In other cases, local city or boroughs may require a license bond, such as the City of Fairbanks requiring all private investigators to have a license bond.

Contract surety bonds are required on many government and private commercial projects. They consist of the bid bond, which basically guarantees the contractor is going to honor their bid and enter into a contract in good faith.

The payment bonds guarantees the principal (contractor) pays their material suppliers, subcontractors, vendors and labor. Failure to do so can result in a claim being filed by the damaged party against that bond. Approximately 80

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percent of claims against contract surety bonds come on the payment bond, where a contractor may run into tight cash flow and doesn't end up paying a bill.

The performance bond guarantees the principal (contractor) will complete the work according to the specs and drawings. The bond provides the obligee (project owner or upstream contractor) with protection against default during a contract.

Contract bond rates generally run from one to three percent, although qualified contractors can get rates lower than one percent.

In most cases, the bonds do not provide protection to the party who purchases them and has the bond in their name. It's for the protection of others. For example, a contractor's license bond is guaranteeing they are going to pay their material suppliers; they are going to pay their taxes; they are going to pay their subcontractors and laborers, and they will complete the job. If any of those things don't happen, the damaged party can file a claim on the bond, up to the face value of the bond.

If the surety company ends up paying out a claim against a bond, through the indemnity agreement signed by the principal, they will attempt to recover their losses from the principal. So in that sense, anyone who has a bond not only has corporate assets at risk, but in most cases, they are also personally indemnified, and thus their personal assets are also at risk. However, unlike insurance, which is designed to cover accidents and mishaps, surety bond claims are well within the control of the principal on the bond. There are no accidental surety bond claims. It generally requires a principal is derelict in their duties to pay their expenses or perform up to professional standards in their industry.

Unlike most insurance policies, surety bonds involve an underwriting process in which not all parties qualify for the bonds, or may pay a much higher rate if the surety determines the risk is excessive. The process involves more than

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wanting a bond and paying a premium, depending on the type of bond and the penal value on the bond. For small bonds, personal credit is the main factor in determining approvals and rates. For larger bonds, a surety company may review both personal and corporate financial statements, business plans, operational capabilities, resumes and prior experience, continuity plans, and a number of other factors depending on the bond need and the surety company.

Rates for bonds vary from less than 1 percent to 10 percent in most cases, although for higher risk principals they may pay as much as 15 or 20 percent of the penal value on the bond. In addition to this premium, local brokers frequently place broker fees on top of the premium in order for them to be profitable enough to handle.

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Let me know if you have any comments, questions, or suggestions.

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