Corporate Exposure: Surety and Fidelity Bonds

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What do surety bonds and fidelity bonds cover—and why are they different from traditional insurance policies?

This is a frequently asked question and often a confusing issue for our clients. Unlike other forms of insurance in which the carrier assumes any and all losses and usually pays on behalf of its insured, bonds do not necessarily respond in the same fashion. One reason for some of the confusion, in fact, is the variety of bonds available (or, in certain cases, required). Each bond is extremely specific as to what it addresses and how it reacts in the event of a loss.

Below, we review some generic differences between surety and fidelity bonds and traditional insurance policies.

Surety Bonds

In general, a surety bond is issued to guarantee the insured's performance. If the insured fails to perform according to the agreement with another party, the bonding company will assume the insured's obligation (as detailed in the agreement) to complete the task—but will then seek reimbursement or repayment from the insured. In theory, the bonding company does not anticipate any losses; traditional insurance is just the opposite.

Traditional insurance bases itself on the assumption of losses and then collects a premium to pay for any such occurrences. As a result, traditional insurance premiums are calculated by various actuarial risk forecasts, whereas bond premiums are typically a premium or fee for a service provided. Further, traditional insurance is a two-party agreement between the carrier and the insured. Bonds are always a three-party agreement among the insured (principal), the obligee (second party to the agreement), and the bonding company (surety) that agrees to guarantee the performance of the insured.

One other significant distinction between traditional insurance policies and bonding coverage is that of cancellation provisions. Traditional insurance may cancel at any time provided sufficient notice is given. With bonds (in most cases) there is no cancellation provision. The bond is released once the insured has performed according to its contract with the obligee. In short, surety is nothing more than a guarantee to perform as agreed.

Be sure you understand the differences between surety and fidelity bonds and traditional insurance policies.

Fidelity Bonds

Fidelity is a type of surety bond, more closely related to traditional insurance. Fidelity bonds cover dishonest or fraudulent acts by an employee. The fidelity contract must be carefully reviewed to determine whether the insuring clause is broad or restrictive in design. Some fidelity bonds cover *any* acts of fraud or dishonesty—such as larceny, embezzlement, forgery, theft, and willful misapplication. These policies can even cover inventory shortages, provided the insured can prove the loss was caused by a dishonest action. Such losses are covered whether the offending employee acts alone or in collusion with others.

It is important to remember that the bond will only respond if dishonest intent can be proven. In other words, any action that constitutes an "honest mistake" will not be covered. Also, the employee need not profit from a dishonest action to activate coverage. A disgruntled employee, for example, acting out a personal grudge to cause a loss to the employer, would be covered under most fidelity bonds, even though he or she did not receive any financial benefit from the action.

Some insuring agreements will only apply to certain named individuals or positions within an organization. If an employee is discovered to have committed a dishonest act, the bond will no longer cover this individual once the insurer is notified. In fact, a fidelity policy will as a rule never again cover such an individual unless specifically agreed upon in writing.

How to Choose

Though hundreds of bonds are written by carriers, they will often fall into one of the following six categories:

1. Judicial Proceeding Instrument
2. Contract Bonds
3. Licensing/Permit Bonds
4. Public Official Bonds
5. Federal Bonds
6. Miscellaneous Bonds

The mechanics of how and when to report a loss, covered amounts, rating issues, the various bonds available, etc., are too involved to be covered adequately here. Suffice it to say, however, that these factors should all be reviewed with your broker. Once that is done, meet with your underwriter and establish an open line of communication.

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