PEO Insider — November 2003

Payroll, Finance, & Admin

PEO Financial Assurance Options Update

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Surety bonds, irrevocable bank letters of credit (LOCs), and certificates of deposit (CDs) are used in the PEO industry to meet state registration and licensing requirements, to provide workers' compensation policy collateral, to guarantee PEO performance of employer responsibilities, and for clients to guarantee payment of service fees. The intent of this article is to provide an update on the use and availability of surety bonds as well as to comment on the use of LOCs and CDs, which now have to be used to meet these obligations when surety carriers won't participate.

When I wrote an article for PEO Insider in April 2002, I commented that because of a combination of the 9/11/01 terrorist attack, the 1/1/02 renewal of reinsurance treaties, and some huge individual losses suffered by the surety industry, obtaining surety bonds would continue to become more difficult and more expensive. The 1/1/03 reinsurance treaty negotiations were as tough or tougher for sureties as in 2002, and this past year has seen the disappearance of some surety giants — Fireman's Fund, Kemper Surety, and Reliance Surety. Therefore, while surety bonds may be the preferred form of financial assurance because of their lower demand on the PEOs financial resources, in today's market they may not be available.

Surety Bonds Versus Letters of Credit

In some ways a surety bond is similar to a LOC. In both instances, fees are paid for the use of the guaranty from the surety carrier or bank. Underwriting requirements include an application questionnaire, business and personal financial statements, business and personal credit ratings, and business and personal guarantees. Neither option is priced assuming a claim or loss will be paid.

A major difference is in the respective appetite for risk of a bank and a surety. An insurance company — whose function is to evaluate risk, charge a premium, and deal with the losses as they arise — underwrites surety bonds. A bank underwriter is not in business to cover losses. This will typically mean two things. First, the LOC will likely have to be 100 percent collateralized by "compensating balances" defined as cash or other collateral on deposit with the bank. Second, banks generally make a Uniform Commercial Code (UCC) filing to secure assets of the company, including receivables, inventory, and fixed assets. Having the PEO's assets pledged in this way can hinder other financing, debt management, and vendor management objectives. With a surety bond, the PEO, and usually the business principals individually (in the case of a closely held company), are required to sign an indemnity agreement holding the surety harmless for any loss and expenses the carrier suffers. An advantage is this guarantee usually is not filed as a UCC document and thus does not impact the PEO's financial flexibility as much as the UCC filing related to an LOC.

State Licensing Requirements

The most common use of surety bonds by PEOs continues to be to meet various state regulatory requirements. Sometimes these bonds are compliance in nature, meaning the PEO must adhere to the states' registration or licensing requirements. In other instances, the bonds are posted so the PEO and its clients are not held jointly and severally liable for unemployment taxes. In still other instances, the bonds are "deficiency bonds," meaning the bond is required due to the PEO's failure to pay certain taxes on time, poor financial performance, or failure to provide financial statements demonstrating certain equity levels. States that require or offer as a compliance option some form of PEO bonding include: Arkansas, Florida, Georgia, Idaho, Louisiana, Minnesota, Michigan, Missouri, Montana, North Carolina, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Oklahoma, Rhode Island, South Carolina, Tennessee, Texas, Vermont, and Wyoming.

Qualifying for these bonds is not typically difficult. Some states allow the PEO to post cash, a CD, or an LOC, but a PEO would likely only do so if required to post collateral for a surety bond. Premiums for bonds are usually 1 to 3 percent. Fees associated with an LOC are usually less but require full cash collateral or compensating bank balances. A CD obviously requires a commitment of cash for a specified period of time and generally will not be acceptable to the agency unless the term of the CD exceeds the term of the security requirement.

Because of these state requirements, a PEO may want to consider membership in the Employer Services Assurance Corporation (ESAC). In addition to the marketing and compliance benefits associated with membership, member PEOs are also automatically approved by ESAC's surety for all state and federal regulatory bonds with no additional financial information or collateral required. Additionally, these bonds are provided at the very favorable rate of .675 percent for the majority of the states. Some states have either approved, or are in the process of approving, legislation to waive bonding and other licensing requirements for PEOs that are

ESAC members, and an initiative is underway to establish this compliance alternative in other states.

Workers' Compensation (WC) Plans

Because of the difficult WC market, PEOs have had to take on more risk to obtain affordable WC coverage. This risk may be assumed under either a large deductible or retrospectively rated plan design, but basically the arrangement results in the PEO reimbursing the carrier for a portion of the risk when claims arise in addition to the base premium paid during the policy period. WC carriers expect some form of financial assurance that the PEO will have the cash to pay its share of the risk when due, because some claim costs may not arise for years. In the early '90s, most surety companies wanted to see net equity of at least $500 million to write a bond to cover the PEO portion of the WC risk. During the mid-'90s, when there was so much competition in the surety market (mainly because of very cheap reinsurance), equity requirements dropped dramatically. Today, because of the losses taken on these bonds and the reinsurance treaties that prohibit these bonds, there is virtually no possibility of covering this risk with a surety bond. Generally, a PEO's only option is to use an "evergreen" LOC because the finite duration of a CD is generally not acceptable to cover the PEO's long-term commitment to reimburse the carrier for its share of the WC losses.

Client Service Agreements

A surety bond can be used to guarantee the performance of either party of a client service agreement. Some PEOs require a cash deposit, surety bond, LOC, or CD to protect the PEO in the event of the financial failure of a client company. An LOC would almost definitely have to be secured by cash or other deposits. Surety bonds would serve well for this purpose because they usually do not have to be secured, as long as the client company can provide a balance sheet showing good equity or the owners have a net worth of at least 10 times the bond amount. An income statement will also have to be provided to demonstrate an acceptable level of profitability.

The other side of this coin is when a potential client expresses concern about what would happen if the PEO failed while holding client payments for an invoice that covers worksite wages, employment taxes, insurance premiums, and contributions to employee retirement plans. If the PEO qualifies financially, it could post a surety bond in favor of each client with this concern. However, this would become very expensive. ESAC membership is again an appealing option in that ESAC's client assurance program provides $1 million individual bonds plus a $3 million aggregate bond as coverage for each member PEO's clients. This type of coverage gives the PEO's clients, employees, taxing authorities, and insurers peace of mind as well as a marketing advantage to bring on new clients.

Proposed Federal Legislation

The pending federal legislation provides for a surety bond or an LOC to be posted as security to qualify for the certified PEO designation and prevents the PEO's clients from having joint and several liability for federal employment taxes. The amount of the bond ranges from $50,000 to $1 million based upon the size of the PEO and the length of time in business.

To qualify for this type of bond, which would contain extensive financial guarantees for your clients, surety companies may want to see 10 to 15 times the bond amount in net equity either inside or outside the company. In today's market, the cost of this type of bond would be approximately 2 to 3 percent of the bond amount. All other things being equal, surety companies prefer equity inside the company rather than outside the company on the owner's personal statement. The fact that the legislation calls for the PEO's financial statements to be audited by an independent CPA and for quarterly CPA attestations regarding tax payments will make writing these bonds much more palatable to sureties.

Surety bonds and "evergreen" LOCs will continue to play an important role in meeting PEO financial assurance requirements. CDs have less application because of their finite term. Because surety bonds do not require collateral in most cases, they generally offer the preferred path if the PEO can qualify. There are two things to be sure to do to maximize your company's chances of being approved for bonding at the best rates possible. First, be prepared to provide all the information you can about the company and its ownership. Second, choose a surety broker with multiple market relationships and a recognized knowledge of the surety needs of the PEO industry. Many companies simply go to their insurance provider for their surety bonds. Although this may seem like the easiest solution, it is prudent to ensure your insurance provider is also a surety specialist. At the very least, it is good to know who your surety carrier is, its A.M. Best rating (A- or better), and what your broker's likely backup market would be if your current carrier exits the surety market.

Jason Jenkins is president of Alpha Surety & Insurance Brokerage, headquartered in the San Francisco Bay area. Prior to joining Alpha Surety, Jenkins was a regional manager for Capital Indemnity and has several years of surety underwriting and management experience with major national brokerage and surety companies.