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Corporate Surety Bonds - Should Obligees Be Concerned About Their Inherent Weakness?

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US construction contractors depend on the surety industry to provide the Performance and Payment bonds routinely required on contracts with municipalities, the state or federal government. The purpose of the bond is to protect the interests of the taxpayers funding such public projects. These bonds are issued by surety companies, and those sureties are often corporations. Most bonds written in the U.S. are issued by such "Corporate Sureties."

There are certain elements worth evaluating in all surety bonds. One is its reliability, because the bond is intended to be a safety net for the benefit of the bond holder (called the Obligee). It will be used to complete the project if the contractor fails to perform (defaults on their contractual obligations) and therefore it is expected that the surety will not also default - thus defeating the purpose of the bond.

A corporate surety bond may include the company's financial statement. The point of this is to show that the surety is solvent and able to pay claims in the future. But unfortunately for the obligee, on a corporate surety bond the financial backing of the bond is only general. It is not specific in the sense that no asset is named or dedicated exclusively to the bond. Corporate sureties are not required to name the asset that backs the bond, and so they always avoid making any such commitment to the obligee.

A second characteristic is that the surety may be permitted to leverage their capital and surplus so that they assume more liability than they could ever honor. Quite simply, this means they do not have enough money to pay all their obligations. This troubling weakness is a potential concern to the obligee holding the bond. If the surety is allowed to issue more bonds than they could ever honor, how is one to know the bond is actually worth having?

The industry attempts to address this inherent weakness by using a rating system. A New Jersey firm, A.M. Best, is in the business of evaluating insurance / surety companies. They attempt to predict if the company will remain in business, and if it appears likely that it will have the capability to pay future claims.

Fortunately for A.M. Best, if they are wrong and the insurance / surety company fails, they have no obligation to the parties harmed by the corporate surety's failure. History shows this has actually occurred. Corporate insurers have failed while enjoying a very high rating from A.M. Best. It is important to note that the Best rating is just an opinion, nothing more. They can be wrong... and have been.

In conclusion, with a corporate surety bond, the financial backing of the bond is general, not

specific. No asset is named. No asset is dedicated to that one bond to secure it. If the surety's assets are lost, there will be nothing preserved specifically to back the bond.

Furthermore, it is possible that even under the best case scenario, the bond is only partially backed because the surety does not have enough money to honor all its obligations.

Bottom line: The A.M. Best rating is an attempt to justify relying on an inherently weak instrument.

The comments / opinions in this article are mine personally, as a result of a 40 year history in the surety industry (most of it working for or representing corporate sureties.) I am not speaking on behalf of my employer in this article.

Be sure to read my companion article on Individual Sureties. They ARE backed 100% by a specified asset that is protected for the exclusive use of the obligee - obviously a much stronger form of bond for the benefit of the obligee.

A 40 year veteran of the surety industry, Steve has worked in a variety of roles and is now Executive Vice-President of The IBCS Group. IBCS is Risk Manager for the Scarborough Bond & Guarantee Program (<http://www.IBCS.com>) which is a major writer of Bid and Performance bonds for contractors.

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