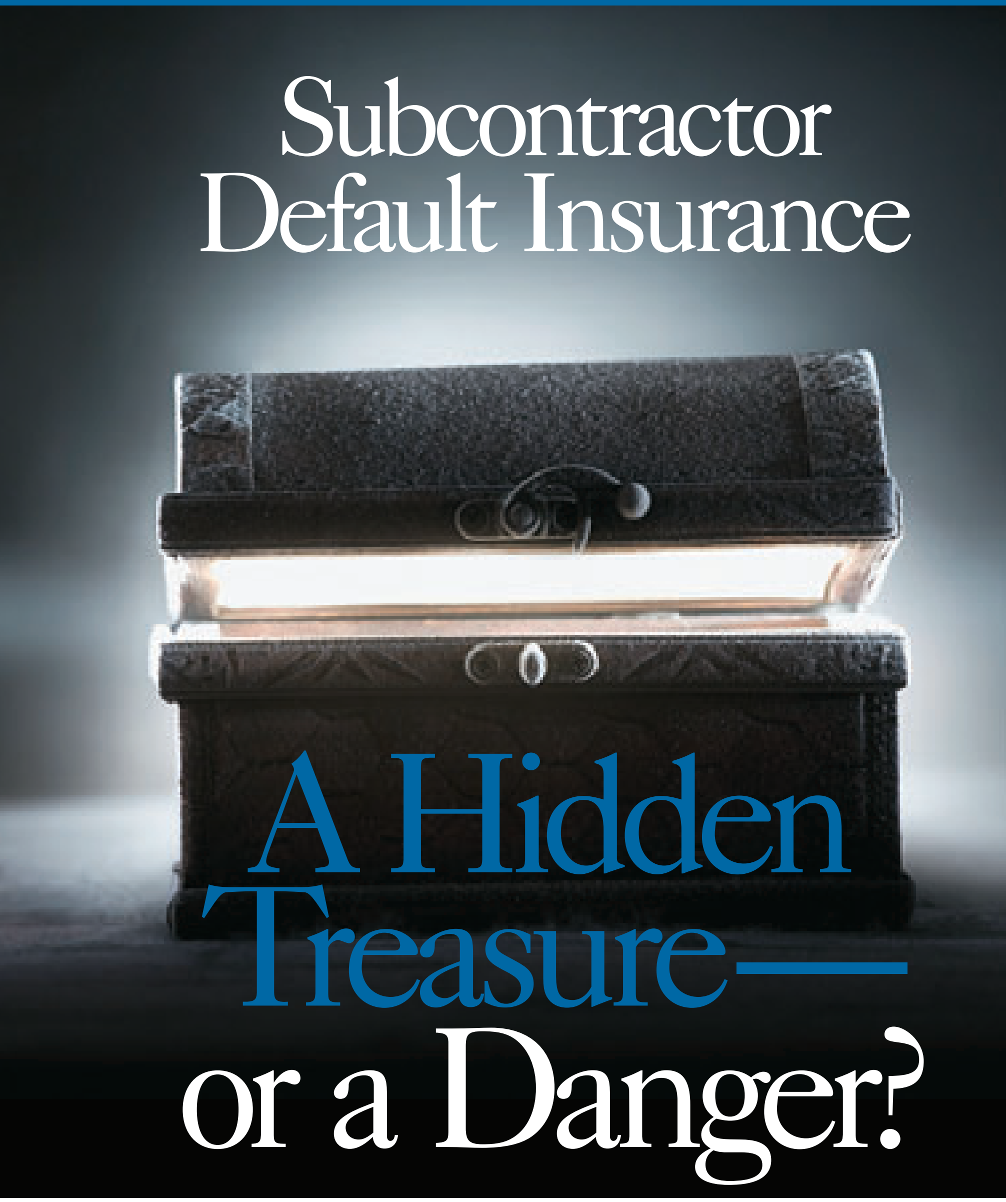

Subcontractor Default Insurance

A Hidden Treasure— or a Danger?

BY MARLA McINTYRE

Subcontractor default insurance (SDI) first appeared in 1996 as an alternative to subcontractor bonding, and a few large prime contractors use SDI to manage their risk of subcontractor default. But SDI is not designed to be used as single project insurance or by contractors that are risk-averse.

SDI is an insurance program covering a line of business that requires contractors to self-insure a significant portion of the risk of subcontractor default through sizeable deductibles and copays, lending itself only to large, sophisticated contractors that possess the personnel and financial resources to undertake a thorough qualification process for all subcontractors. Just one insurer writes SDI for contractors with an annual subcontract volume exceeding $50 million.

Contractors should know a host of things about SDI before looking for buried treasure.

UNDERSTANDING SURETY BONDS

Some think default insurance can replace performance and payment bonds on contracts. SDI is an alternative to bonding subcontractors, but it is important to understand the differences between insurance and surety bonds.

Prime contractors that require performance and payment bonds from their subcontractors:

- are protected from paying twice for the same work items if the subcontractor fails to pay his subcontractors and suppliers;
- are generally viewed favorably by their surety company; and
- receive assurance that the subcontractors are qualified to perform their work. This pre-bid requirement elevates the quality of subcontractor bids and eliminates problems that may occur with lesser quality or unqualified subcontractors.

PREQUALIFICATION

With SDI, the general contractor or at-risk construction manager prequalifies its subcontractors using its own program, criteria and resources. While general contractors will perform some level of due diligence before awarding a subcontract, some subcontractors object to providing confidential financial information and other sensitive data to the general contractor. Subcontractors are more comfortable sharing this data with a surety team that uses a thorough prequalification to identify ways to strengthen the subcontractor's business.

Sureties view contractor and subcontractor default as avoidable, not inherent, in construction. During the underwriting process, the surety focuses on the qualifications of the principal, examining in depth the principal's credit history and financial strength, experience, equipment, work in progress, character, management experience and capability.

After the surety assesses these factors, it determines the appropriate amount of surety capacity. Not all contractors and subcontractors can qualify for surety bonds. This process assures the general contractor it is retaining a subcontractor that, in the opinion of the surety, is fully capable of performing its construction contract.

Proponents of SDI may claim the surety industry's ability to provide bonds is limited by capacity. In fact, construction rose 5 percent from 2001 to 2005 (excluding single family residential), and public construction, which is usually bonded, rose 20 percent. The amount of contract surety bond premium written increased 37 percent during the same period. If a contractor's or subcontractor's bonding capacity is limited or denied, it is a qualification issue because sureties are adhering to disciplined underwriting practices.

PRICING

Given the risk assumed by the surety, bonds are very affordable. The cost of performance and payment bonds is calculated on the contract amount and generally ranges from 0.5 percent to 2 percent, depending on the size and type of the project and the subcontractor's bonding capacity.

The pricing of SDI assumes the inevitability of subcontractor defaults, imposing substantial per-loss deductibles (from $250,000 to $1 million) and copayments. The policy premium depends on the deductibles and copayments selected and the contractor's profile and subcontract volume, and it may be approximate to the cost of bonds. However, the SDI premium does not reflect other significant costs requisite for its use, specifically the costs to the contractor of qualifying subcontractors and administering claims.

INDEMNITY

A surety rigorously scrutinizes the principal's qualitative and quantitative characteristics by viewing its underwriting as a form of credit, much like a lending arrangement. In fact, as a condition of the bond arrangement, a surety usually requires the principal to execute a general indemnity agreement that the principal will indemnify the surety for any costs and expenses paid out under the bonds. Such an arrangement provides a considerable incentive for the subcontractor to resolve project problems.

CLAIMS HANDLING

According to BizMiner, specialty contractors experienced a 24.5 percent default rate from 2004 to 2006. For start-up firms with one year or less in business, the failure rate rose to 36.3 percent. Given those odds, not many contractors can absorb that risk. Subcontractor surety bonds protect a contractor in two ways—by eliminating those subcontractors likely to fail and by remedying the default should it occur.

With an SDI policy, the general contractor can take immediate action to remedy the perceived default. However, when the contractor submits the claim to the SDI carrier, it still needs to provide documentation and proof of the default. In the event of default on a bonded project, a surety has an obligation to all parties to investigate the claim to ensure its legitimacy. If the subcontractor is in default, the surety completes, arranges for or pays for the contract completion up to the amount of the bond.

With SDI, a contractor that declares default is subject to later judicial review. The contractor also manages the default, including completion of the contract and filing the claim with the insurer. If documentation is not provided, or it is determined the default was inappropriate, the contractor is required to repay the insurer any amounts paid by the insurer to the contractor.

PUBLIC CONSTRUCTION

The federal Miller Act and state "Little Miller Acts" require contractors to furnish payment and performance bonds for public construction projects of a certain size—$100,000 on federal construction projects and usually $25,000 or more on state construction projects. Keep in mind that contractor default insurance does not exist. SDI is not a risk transfer mechanism with a direct benefit to the public project owner and is not intended to replace performance and payment bonds furnished by the general contractor on a public project.

A contractor can then choose to use SDI on a public project instead of bonding subcontractors. However, SDI does not include any claim rights by subcontractors and material suppliers for payments under the policy. As a result, a requirement for SDI in lieu of subcontractor payment and performance bonds clearly does not address one of the vital public policies underlying federal, state and bonding statutes ensuring payment to sub-subcontractors, laborers and material suppliers that do not possess lien rights on public construction projects.

LEGAL PRECEDENTS

Surety bonds have a long history of legal precedent establishing the rights, duties and obligations of the surety, principal and obligee. SDI does not have the body of law surrounding the interpretation and enforcement of the various provisions, and very little is known about the number and volume of claims against SDI policies. One large contractor stopped using SDI after a high-profile subcontractor defaulted and the loss exceeded the policy limits. Insurance contracts generally have specific rules for determining the scope and breadth of coverage for certain claims depending on the language of the policy.

PLACEMENT OF BURDEN

With subcontractor performance bonds, the burden of resolving subcontractor default issues is transferred from the contractor to the surety. After investigating the bond claim, the surety, among other

Issues	Performance & Payment Bonds	Subcontractor Default Insurance
Prequalification process	• Conducted by surety	• Left to policyholder
Structure	• Three-party agreement	• Two-party insurance policy
Payment protection for subcontractors and suppliers	• Yes, covered 100 percent by payment bond • Direct payment protection	• Not covered • Unable to file a direct claim with the insurer
Default management	• Claims investigated by surety to ensure legitimacy • If subcontractor defaults, surety completes, arranges for, or pays for the contract completion up to the amount of the bond	• Contractor declares default subject to later judicial review • Contractor manages default, including completing the contract and filing the claim with the insurer
Risk	• Shifted to surety for contract completion and payment to subcontractors and suppliers	• Contractor retains a portion of the risk through deductibles and copayments; sub-subcontractors and suppliers bear risk of nonpayment
Legal	• Required by federal and state law on public projects • Long history of case law and legal precedents	• Does not satisfy federal or state bond requirements • Little history of case law or legal precedence

things, will assist the contractor by addressing unpaid creditors, finding a replacement subcontractor (if necessary) and assuring the completion of the subcontract work. In addition, the contractor still must provide documentation of the default and the losses it caused and the fact that the contractor was right in declaring a default.

SDI offers contractors the ability to take immediate action upon a subcontractor default, then seek reimbursement under the SDI policy, subject to its deductible, a copay and submission of proper documentation. But, SDI places the burden on the contractor to resolve subcontractor default issues, thereby distracting the contractor's focus from completing the project. Under SDI, the insured is entitled only to monetary reimbursement, not services or assistance, upon subcontractor default.

In addition, subcontractor performance bonds cover subcontract defaults for the period specified in the subcontract, the bond form or the applicable statute of limitations, which typically runs longer than the completion of the work. On the other hand, SDI is a "claims-made" insurance policy that requires all default claims to be made during the term of the insurance, which may not encompass the full period for the completion of the work. Furthermore, sureties often prevent actual default by financially supporting a principal, thereby keeping the project moving.

UNDER SDI, THE INSURED IS ENTITLED ONLY TO MONETARY REIMBURSEMENT, NOT SERVICES OR ASSISTANCE, UPON SUBCONTRACTOR DEFAULT.

"Subcontractor default insurance is a two-way street between an insurer and a prime contractor, with subcontractors curbside crossing their fingers hoping nothing goes wrong," says Tim Kennady of Contemporary Floors Inc. (CFI), Concord, Calif. "It's critical that subcontractors understand the differences between surety bonds and this insurance product. Payment protections for subcontractors are entirely absent from SDI unlike on a project with a payment bond. If a subcontractor isn't paid for its work, SDI doesn't take claims for nonpayment.

"Additionally, unlike a performance bond, SDI does not require third-party assessment of a declaration of default. Subcontractors used to working on bonded projects could see the lack of a surety to investigate a declaration of default as a disadvantage. A prime contractor could decide to replace the sub and make a claim against the SDI insurer to recoup the costs. Without surety prequalification, SDI could also encourage projects to be low-bid rather than use the best qualified subcontractors."

McIntyre is executive director of the Surety Information Office, Washington, D.C. For more information, call (202) 686-7463 or email mmcintyre@sio.org.

SDI: The Subcontractor's Perspective

Imagine a commercial flooring installation subcontractor is competing for work with a prime contractor for the first time. What difference would the use of a performance bond versus SDI make from the subcontractor's perspective?

The subcontractor would prepare and submit sensitive financial and business information regarding its qualifications for the project. With a performance bond, the information goes to a surety company—with SDI, to the prime contractor. Because the prime contractor has the contractual obligation to pay the subcontractor and may even be its competitor on future projects, the subcontractor may not feel comfortable supplying such sensitive information. How the prime contractor evaluates or uses the subcontractor's information is unclear.

A surety company, on the other hand, is a third party with underwriting standards, and that sensitive information is kept confidential. Additionally, with SDI, the new subcontractor competing for work is at a disadvantage because each new subcontractor added under an SDI policy starts a separate deductible. The prime contractor has a financial incentive to use the subcontractors it has used previously under the policy instead of using new subcontractors.

Performance bond subcontractor qualification does not create the same inequality. SDI may allow the participation of lower-quality bidders as well, because under an SDI policy the prime contractor can make claims for the cost of a replacement subcontractor after it unilaterally declares a subcontractor to be in default. Under a performance bond, a surety makes the determination of whether a subcontractor default has taken place and independently handles any associated costs.

Imagine a steel erection subcontractor performed hundreds of thousands of dollars of work on a project, but then an intractable and potentially costly dispute arose about whether some of the work was within the scope of the original subcontract and whether it obtained the appropriate permission to proceed with that work. What difference would the use of a payment bond versus SDI make from the subcontractor's perspective?

If the prime contractor decided not to pay the subcontractor for part of the work and a payment bond was supplied on the project, the subcontractor could make a claim up to the bond limit. The surety would investigate the claim and could make a determination. If it determined the subcontractor was wrong, the subcontractor wouldn't receive payment; if the prime contractor was wrong, the subcontractor would get paid and the surety could seek recovery of the payment from the prime contractor. With SDI, there would be no entity assuring payment to the subcontractor. The subcontractor would have to initiate litigation or alternative dispute resolution processes.

As a two-party insurance product between an insurance company and a prime contractor, SDI does not cover subcontractors' claims for nonpayment. For a subcontractor, if the cost of pursuing payment (i.e., attorney fees, travel, court costs, time away from the company, etc.) approached or outweighed the payment itself, the subcontractor would have a disincentive to collect the unpaid amount. Under SDI, the cost of pursuing payment is the subcontractor's concern. Under a payment bond, normally it is the surety's concern.

On public projects, subcontractors cannot place liens against public property. Without lien rights and a payment bond in place, subcontractors may have no payment recourse.