by Robert J. Duke

"Subcontractor default insurance does not perform or offer the same extent of protection as subcontractor bonds."

SURETY BONDS: THE BEST WAY TO PREVENT SUBCONTRACTOR DEFAULT

For more than ten years, subcontractor default insurance has been promoted as a substitute for subcontractor performance bonds.[1] However, there are significant differences between bonds and default insurance.

Subcontractor default insurance does not perform or offer the same extent of protection as subcontractor bonds. Two of the key differences between surety bonds and subcontractor default insurance are prequalification and payment protection. As these differences become clear, surety bonds stand out as the most effective means to prevent subcontractor default and assure payment to the subcontractor's subs and suppliers.

Prequalification

A surety seeks to avoid a default by providing bonds only to those contractors it believes are qualified to perform the work. Long ago, the book of Proverbs cautioned against being a "surety for a stranger."[2] Effective and successful surety bond underwriting requires the surety to know the subcontractor's operation fully. A surety examines the subcontractor's character, capacity and capital to be as certain as it can be that the subcontractor can perform the work to be bonded. The surety reviews the subcontractor's financial statements, evaluates the subcontractor's experience and assesses the subcontractor's organization and equipment. The surety typically will obtain the following information from the subcontractor:

- Quarterly financial statements
- Updated backlog data
- Bank letter regarding any line of credit
- Organizational information
- Business plans/bonding needs
- Information regarding the specific project to be bonded including a copy of the construction contract

Moreover, underwriting is a continuing process for as long as the surety is providing bonds to the subcontractor. In light of this extensive prequalification process, it is not surprising that subcontractors often have long-standing relationships with their sureties. Subcontractors understandably want to limit the number of parties that have access to their proprietary information. In addition, a surety that has a long relationship with a subcontractor likely will be more willing to provide bonding credit on a project that might be a "stretch" for the subcontractor than a surety that is new to the subcontractor.

Subcontractor default insurance attempts to implement a prequalification scheme as well. The policy marketed by Zurich North America, Subguard, permits the insurer to cancel the policy "[u]pon repeated violations in the application of your Qualification procedures."[3] "Qualification procedures" is defined as "written criteria that you have represented that you will adhere to in order to assure that the Subcontractor/Supplier will be able to carry out the terms of the Covered subcontract or purchase order agreement."[4] Thus, the policy relies on the contractor to implement its own prequalification procedures. However, this prequalification is a lesser substitute to the prequalification performed by a surety bond for three reasons.

1. The prequalification scheme contemplated under subcontractor default insurance is not available to all general contractors. Generally, only large contractors have the resources and personnel necessary to review subcontractor qualifications. In fact, the product is available only to large contractors that meet a minimum threshold for subcontractor/supplier expenditures. The prequalification services offered by a surety bond are available to any general contractor that requires a performance bond from its subcontractors.
2. Although a general contractor may have the resources and personnel to review a subcontractor, its prequalification process cannot match the detailed and continuing review provided by a surety. A general contractor that has a prequalification process typically requires the subcontractor to complete a questionnaire regarding its operation and annually submit a financial statement. Although the questionnaire can be detailed, the prequalification pales in comparison to the surety's review. For example, contractor questionnaires typically require an annual financial statement. A surety will require an annual financial statement, quarterly financial statements and quarterly work on hand schedules. Based on the extent of information provided, a surety likely will be able to detect problems on the subcontractor's other projects before the general contractor detects a problem. Experience shows that the subcontractor's weaknesses that caused the problems on the other projects eventually find their way to the project being bonded. A limited review of a financial statement, which is only a snapshot of the subcontractor's financial position at a point in time, likely will not detect problems that do not exist at the time of the financial statement. Interestingly, perhaps as an acknowledgement of the quality of a surety's prequalification, many questionnaires require the subcontractor's surety to provide a letter that indicates that the subcontractor is bondable for a certain amount.
3. Subcontractors are uncomfortable providing proprietary information required in the prequalification process to general contractors.[5] Given the long-term relationship between subcontractor and surety, a subcontractor likely is less hesitant to share its company information with its surety.

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The president of the American Subcontractors Association Midwest Council commented on the thoroughness of surety prequalification relative to the review by a general contractor by stating, "In the case of our surety, I am confident that it looks at more than just financial statements, as I work very closely with our insurance company and surety to ensure that they understand the type of work we do and the risks and benefits of this type of work."[6]

Prequalification is the chief protection against loss under surety bonds. Because the prequalification scheme under default insurance falls short in certain respects, the subcontractor default policy imposes other terms and conditions to mitigate the insurer's loss—terms and conditions that are not in a surety bond.[7]

Coverage is subject to an aggregate limit for all subcontractor losses under the policy. Thus, depending on the particular aggregate limit on the policy, multiple subcontractor losses on a project could lead to less than 100 percent coverage. A surety bond secures 100 percent of the subcontract amount. In addition, a subcontractor default policy may be subject to a deductible. Thus indemnity is afforded under the policy after application of the deductible amount, which can be in the $500,000 range.[8] A surety bond does not have a deductible.

A subcontractor default policy typically is subject to a number

of exclusions (Subguard Policy, Exclusions, § III.), so that coverage does not apply to loss:

> "B. Arising from any Subcontractor/Supplier who is in or to whom you have issued a written notice of Default of performance and said default has not been cured as of the first day of the Policy period, unless this is a renewal of a Policy previously issued by us, in which case you must disclose such Default of performance at [sic] of the renewal date of this policy. …
>
> C. To the extent caused by any dishonest or fraudulent act or omission, or any misrepresentation committed by you….
>
> E. To the extent caused by a material breach of or inaccuracy regarding any Warranty and covenants, in accordance with Section IX or this Policy, made herein or a material failure to perform or to fulfill any warranty, covenant, or agreement made by you ….[9]"

Thus, a requirement of coverage is that the contractor must abide by certain warranties and covenants. Among these are a warranty to take all necessary actions to preserve right of recovery against a subcontractor in the event of an insolvency or default of a subcontractor, and a warranty to use all reasonable measures to mitigate a loss.[10] A contractor is also required to retain the deductible amount.[11]

Payment Protection

In addition to prequalification, subcontractor default insurance falls short when it comes to coverage of the subcontractor's payment obligations to its sub-subcontractors and suppliers ("Subsubs"). Subcontractor default insurance only insures the general contractor against loss caused by the "Default of performance" by the "Subcontractor/Supplier."[12] Default of performance is defined as the "failure of the Subcontractor/Supplier to fulfill the terms of the Covered Subcontract."[13] Nonpayment by a subcontractor to its Subsubs conceivably could be a "Default of performance" if such payment obligations are set forth in the contract between the general contractor and subcontractor. However, subcontractor default insurance indemnifies the general contractor against loss. If the subcontractor's nonpayment to its Subsubs does not cause a loss to the general contractor, there is no coverage. In addition, default insurance does not protect the Subsub against loss caused by nonpayment. A Subsub cannot make a claim under default insurance. Thus, the owner and general contractor still may have the risk that the subcontractor will not pay its Subsubs.

On the other hand, a payment bond provided by the subcontractor can provide the Subsubs 100 percent security of the subcontractor's payment obligations and protect the owner and general contractor from the risks of nonpayment. In addition, the Subsub can make a claim directly against the payment bond.

As a construction business owner contemplates how to manage his or her subcontractor default risk, the owner is advised to conduct a side-by-side comparison of the alternatives: subcontractor performance and payment bonds versus subcontractor default insurance. The two general risks regarding subcontractor default are that the subcontractor will not complete the work according to the subcontract and that the subcontractor will not pay its Subsubs. A close review of the products' features in the area of prequalification and payment protection show that surety bonds remain the best way to prevent subcontractor default and to provide the most robust payment protection. ■

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[1] See, e.g., Todd Rowland, Managing Contractor Default Risk, Contractor Default Insurance: A Bond Alternative (presentation), 20th IRMI Construction Conference, (2000), at www.irmi.com/Conferences/Crc/Handouts/Crc20/Default/ABondAlternative.pdf

[2] Proverbs 11:15 ("He that is surety for a stranger shall smart for it . . . .").

[3] Subguard Policy, Conditions, Cancellation, § X.B.4 (11/03). At present, Zurich is the only insurance company that has a subcontractor default insurance product, despite predictions that the concept would be replicated by competitors. Debra K. Rubin & Tony Illia, Subcontractor Default Insurance Gains Attention in Tougher Times, ENR.com (April 14, 2003), available at enr.construction.com/features/bizlabor/archives/030414.asp (predicting that Subguard is "soon to be emulated by others").

[4] Id. Definitions, § II.K.

[5] Managing Dispute Resolution Options in the Construction Industry, 62 Disp. Resol. J. 23 (July 2007). During a construction industry roundtable, a construction attorney noted that subcontractors do not want to turn over their financial information to a contractor because "they may not want to disclose all this financial information." Id. at 33.

[6] Peter Downs, Some Subs Annoyed with Subguard, Stl ConstructNet (October 2005), at www.stlconstruction.com/story/1005/8.html

[7] The policy provisions discussed in this article are taken from the 11/03 Subguard Policy. We understand that the policy is subject to revisions and negotiation.

[8] James Higgins, Subcontractor default insurance, Insurance Journal (January 8, 2007), at www.insurancejournal.com/magazines/midwest/2007/01/08/features/76235.htm

[9] Subguard Policy, Exclusions, § III.

[10] Subguard Policy, Warranty and covenants, § IX.B and .IX.C.

[11] Subguard Policy, Exclusions, § IX.D.

[12] Subguard Policy, Insuring Agreement, § I.

[13] Subguard Policy, Definitions, §§ II.D.