subcontractor to completion, or negotiate a financial settlement with the contractor and issue payment. In addition, subsubcontractors, laborers, and suppliers under the subcontract are guaranteed payment by the payment bond. Sub-subcontractors may file a claim for payment directly with the surety.

With SDI, the GC is responsible for handling all aspects of a default situation. The prime contractor is expected to pay all losses initially and then seek reimbursement from the insurer. This effect on the principal's cash flow can have a significant impact on the ability to pay its subcontractors. Also, if a subcontractor suffers a loss due to the contractor's failure to pay, he or she has no right to file a claim directly with the insurer. If the prime contractor decides not to, or is unable to, pay a subcontractor, he or she has no recourse to file a claim for the money owed.

Final Thoughts

A surety bond is a comprehensive risk transfer mechanism that provides the prequalification of subcontractors; shifts the entire risk of the principal's default from the obligee to the surety; requires the surety to manage default situations; and provides 100% payment protection to certain subcontractors and suppliers. SDI is often described and marketed as an alternative to traditional performance and payment bonds, but it is merely a traditional insurance policy and provides no payment protection for subcontractors, suppliers, and laborers.

Surety Information Office (SIO)
www.sio.org
sio@sio.org

The Surety Information Office (SIO), formed in 1993, disseminates information about the benefits of contract and other forms of surety bonding in private and public construction. SIO, a virtual office, is supported by the National Association of Surety Bond Producers (NASBP), www.nasbp.org, and The Surety & Fidelity Association of America (SFAA), www.surety.org. For information on the benefits of surety bonds in construction and in other contexts, contact the Surety Information Office at sio@sio.org.

National Association of Surety Bond Producers (NASBP)
1140 19th St. NW, Suite 800
Washington, DC 20036
(202) 686-3700
(202) 686-3656 Fax
www.nasbp.org
info@nasbp.org

The National Association of Surety Bond Producers (NASBP), founded in 1942, is the association of and resource for surety bond producers and allied professionals. NASBP producers specialize in providing surety bonds for construction contracts and other purposes to companies and individuals needing the assurance offered by surety bonds. NASBP producers engage in contract and commercial surety production throughout the U.S., Puerto Rico, Guam, and a number of countries. They have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.

The Surety & Fidelity Association of America (SFAA)
1140 19th Street, NW, Suite 500
Washington, DC 20036
(202) 463-0600
(202) 463-0606 Fax
www.surety.org
information@surety.org

The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.

Surety Bonds vs. Subcontractor Default Insurance

Important Differences

Surety Bonds vs. Subcontractor Default Insurance

Subcontractor default insurance (SDI) has received attention, primarily among very large contractors, as a way to manage risk of subcontractor failure. The product, introduced in 1996, is marketed to contractors who are willing to accept and manage risk of subcontractor default. However, subcontractors on these projects may end up in a precarious position, as a number of benefits provided by performance and payment bonds are absent under current SDI policies. Before working on a project covered by SDI, owners, general contractors (GCs), and subcontractors should consider the potential risks of default insurance and benefits of surety bonds.

Surety Bond	Default Insurance
Regulated by state insurance departments	Sold
Three-party (protects obligee; risk stays with principal and surety). Surety has obligations to obligee and principal.	Two-party (protects insured). Insurer has obligations to insured.
Premium is actuarially based and takes into consideration the potential for loss, but also is a fee for prequalification services; based on size and type of project and contractor's bonding capacity	Premium – actuarially determined (calculated pooled risk)
Coverage is project-specific.	Coverage usually is term-specific.
Bond forms are standard or may be negotiated by owner or surety.	Form is mandated by insurance company.
Claims – Surety has right to contract balance or indemnity	No right to insured's assets; however, companies can subrogate against a third party or another insurer.

Managing Risk

Construction is a virtual minefield of risk, and owners and contractors always are looking for ways to identify, assess, and manage it. While insurance and surety are frequently lumped into one general category of risk management, surety is a unique type of insurance with significant differences. Contract surety bonds are highly effective tools for owners and contractors to shift the risk of contractor and subcontractor failure, and for ensuring that a qualified contractor or subcontractor that is capable of completing the contract is on the job.

An SDI policy is a two-party agreement between the insured (the contractor) and the insurer that indemnifies the contractor for costs incurred as a result of a subcontractor's performance default. SDI provides no coverage to an owner and no protections to other subcontractors, suppliers or laborers. A surety bond is a three-party agreement in which the surety guarantees to the obligee (in this case, the contractor) that the principal (the subcontractor) will perform a construction contract. Surety bonding involves a rigorous process in which a surety company prequalifies the contractor or subcontractor and provides assurance that the contractor or subcontractor will perform according to the terms of the contract.

A performance bond protects the owner and GC from financial risk should the contractor or subcontractor default on its contract. A payment bond protects certain subcontractors, suppliers, and laborers, ensuring that they will be paid subject to any restrictions and limitations imposed by statute, the contract or subcontract, or the bond.

Surety Bonds Provide a Level Playing Field

What if the prime contractor requires subcontractors to obtain a performance bond? In order to obtain a surety bond, subcontractors undergo a rigorous prequalification process. Prequalification is a major underpinning of the surety bond product. To qualify for a bond, subcontractors must provide, among other information, confidential financial data, details of work-in-progress, and a comprehensive business plan to the surety company underwriter, who determines whether to bond the subcontractor.

Through the prequalification process, the underwriter analyzes the contract documents', size and location of the project, as well as the subcontractor's financial strength and credit history; experience and reputation; exposure and progress on other contracts; and ability to perform the work.

A surety company will issue a bond only if it believes that the subcontractor will fulfill its contractual obligations. So, when bonds are required, subcontractors will be bidding against other qualified subcontractors. However, with SDI, the prime contractor must perform its own prequalification, which is unlikely to be as thorough as the surety's. Although the prime contractor can determine a subcontractor's ability to perform the work, without the confidential data and information provided to the surety company, it is difficult for the prime contractor to evaluate the subcontractor's entire workload, status, and profitability when awarding the contract.

Claims

According to Bizminer, of 532,756 specialty trade contractors in business in 2010, only 410,808 were still in business in 2012, a 23% failure rate. Given these odds, it is important that owners and contractors have a safeguard in place to protect against subcontractor default. A surety bond, with its prequalification process, should eliminate those "likely to fail" subcontractors.

SDI allows the contractor to declare a default and replace a subcontractor on a project, subject to repayment if the default is determined to have been unjustified. On a bonded project, the surety conducts an independent investigation to determine whether a subcontractor truly is in default.

Should subcontractor default occur, the surety takes the responsibility to deal with certain unpaid creditors, suppliers, and laborers, and sees that the contract is completed. The surety may bring in a replacement subcontractor to complete the work, finance the present

Performance & Payment Bonds vs. SDI

Issues	Performance & Payment Bonds	Default Insurance
Prequalification Process	• Conducted by surety	• Left to policy holder
Structure	• Three-party agreement	• Two-party insurance policy
Payment Protection for Subcontractors & Suppliers	• Yes, covered by 100% payment bond • Direct payment protection	• No • Unable to file a direct claim with 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 completion of the contract, & files claim with insurer
Risk	• Shifted to surety for contract completion & payment to subcontractors & suppliers	• Contractor retains portion of risk through deductibles & co-payments; sub-subcontractors & suppliers bear risk of nonpayment
Legal	• Required by federal & 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