Surety News Bulletin

Subcontractor Payment Rights Not Protected Under Default Insurance Policies

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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 being 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 subcontractor default insurance, subcontractors should consider the potential risks and benefits of default insurance and contract surety bonds.

Managing Risk

Construction is a virtual minefield of risk, and contractors are always looking for ways to identify, assess, and manage it. Many equate "risk management" with insurance, but insurance is not the only method of managing risk – especially on construction projects. While insurance and surety are frequently lumped into one general category of risk management, surety is a specialized type of insurance with significant differences. Contract surety bonds are a highly effective tool for contractors to shift the risk of subcontractor failure, and for ensuring that a qualified subcontractor is on the job who will complete his/her contract.

Surety Bond	Default Insurance Policy
• Regulated by state insurance departments	• Sold as surplus lines, not regulated
• Three party (protects obligee, risk stays with principal & surety) Surety has obligations to obligee and principal	• Two party (protects insured) Insurer has obligations to insured
• Premium fee for qualification services (no expectation of loss) based on % of contract amount	• Premium actuarially determined (calculated pooled risk)
• Coverage project specific	• Coverage usually term specific
• Bond forms standard or may be negotiated by owner or surety	• Form 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

A subcontractor default insurance 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.

A surety bond is a three-party agreement under 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 careful, rigorous, and professional process in which a surety company and producer prequalify the subcontractor and provide the general contractor assurance that the subcontractor will perform according to the terms and conditions of the contract.

A performance bond protects the general contractor from financial risk should the 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 confidential financial data, details of work-in-progress, and a comprehensive business plan to the surety bond producer and surety company underwriter, who determines whether to bond the subcontractor.

Through the prequalification process, the surety bond producer and underwriter analyze 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 with legitimate bids. However, with SDI, the prime contractor must perform its own prequalification, which is not likely 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 bond producer and surety company, it is difficult to evaluate the subcontractor's entire workload, status, and profitability. A subcontractor's ability to perform the contract, work history, and reputation in the industry should be given significant consideration by the prime contractor when awarding the contract.

Claims

According to Bizminer, of 728,343 specialty trade contractors in business in 2002, only 517,885 were still in business in 2004, a 29% failure rate. The failure rate increases to 37% for start-up specialty trade contractors. Given those odds, it is important that 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.

Subcontractor default insurance gives the contractor latitude to declare a default and the power to unilaterally 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 unpaid creditors, suppliers, and laborers, and frequently administers the contract to completion. The surety may bring in a replacement subcontractor to complete the work, finance the present subcontractor to completion, or negotiate a financial settlement with the contractor and issue payment. In addition, sub-subcontractors, 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 according to established criteria; 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 subcontractors and suppliers. SDI is often described and marketed as an alternative to traditional performance and payment bonds, but it is merely an insurance policy, and provides no payment protection altogether for subcontractors, suppliers, and laborers.

Performance & Payment Bonds vs. Subcontractor Default Insurance

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 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 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

Disclaimer: Due to the changing nature of default insurance policies, information contained herein may not reflect current standards. Please visit www.sio.org for the most up-to-date information.