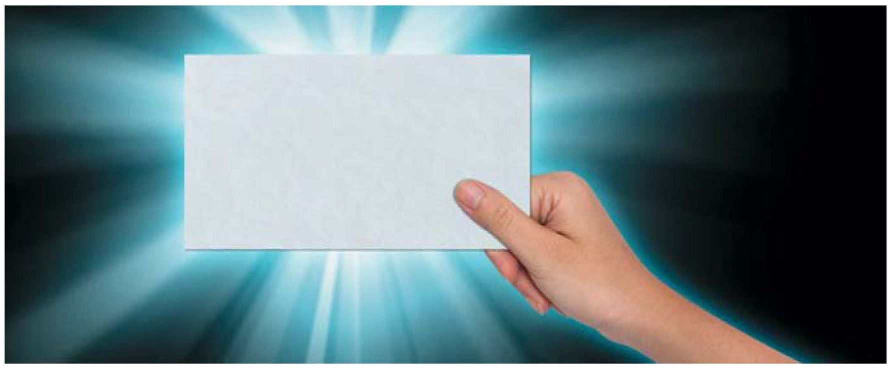
Feature

Managing Subcontractor

RISKS OF NON-PERFORMANCE AND FINANCIAL FAILURE

A Flash Guide to Subcontract Bonds and Subcontractor Default Insurance



THE PRINCIPAL MEANS of mitigating subcontractor default risks is through a process of subcontractor prequalification. For more than a century, surety companies have provided regular, in-depth third-party prequalification services to general contractors by extending surety credit to subcontractors through bid, performance, and payment bonds. Those subcontractors that merit surety credit receive guarantees of performance and payment in the form of subcontract surety bonds, three-party contracts, which are, in turn, provided to prime contractors upon subcontract award. Only a subcontractor determined by the surety under its underwriting criteria to be fully capable of performing its subcontract obligations is accorded surety credit. The surety closely examines the wherewithal of each subcontractor: its financial strength, credit history, project experience, reputation, progress on other subcontracts, management capability, equipment, size and geographic location of work, and other factors. It is a thorough and confidential process centered on the subcontractor's history of performance and its on-going work program and focused on the crucial tenet of preventing incidences of subcontractor default from the onset. Bonded subcontractors are further incentivized to complete subcontract obligations, as sureties, believing their bonded subcontractors are capable of performing, require personal and corporate indemnities from those subcontract firms in the event that the sureties have to pay out under the bonds.

Subcontractor prequalification also is a component of a two-party, catastrophic insurance policy, subcontractor default insurance (SDI), first developed approximately 20 years ago, to provide general contractors with insurance coverage for direct and indirect costs of trade contractor default. Some general contractors, generally those with subcontract volume exceeding $50 million, that are eligible for SDI coverage see it as an alternative to the purchase of subcontract bonds. Unlike subcontract bonds, SDI is traditional insurance that presumes some level of losses; and general contractors that purchase SDI coverage must bear a significant level of self-insurance for such risks through high deductibles and co-payment requirements. The burden of subcontractor prequalification is borne by the insured general contractor, which must make a substantial investment of resources to create an adequate company infrastructure and culture to ensure proper prequalification of subcontractors. Such a structure is incented by the fact that the insured general contractor will need to build a reserve to pay for deductibles and any co-payments arising from enrolled subcontractor losses in its SDI program. Little or no losses in the SDI program eventually translate into higher margins for the insured general contractor. On the other hand, significant losses can jeopardize the operational ability of an insured general contractor that will bear the expenses of the deductibles and the co-payments and the significant burden of administering claims. The benefits of SDI flow only to insured general contractors, but such benefits can be significant if the insured contractor strictly maintains a well-managed, sophisticated SDI program, with few or no losses.

It is critical to understand that SDI, as a product very different from surety bonds, never is a replacement for statutory federal, state, or local bond requirements, whether such statutory requirements dictate bonds at the prime or subcontract levels. Bond statutes have been in place for many decades and were enacted on well-affirmed public policy grounds: specifically, performance bonds protect publicly funded investments in construction by furnishing public owners with first-dollar coverage for contract defaults; and payment bonds provide specific project parties, various downstream subcontractors and suppliers furnishing labor, materials and equipment, with payment remedies in the event of their nonpayment. Trade contractors, which are not in privity with project owners, have no other payment recourse than the payment bond when they go unpaid on public work, as mechanics' liens are not available against public property. These fundamental public policy reasons for statutory bond requirements are not answered by the general contractor's SDI program.

The following chart is a broad overview of features and purposes of subcontract bonds and SDI. Following is a point-by-point comparison of key aspects of each, providing further insights and additional paths for self-directed inquiries of the respective products, helping an assessment of their suitability for any given situation. ●

The Features and Purposes of Subcontract Bonds and SDI

ISSUE	PERFORMANCE AND PAYMENT BONDS	SUBCONTRACTOR DEFAULT INSURANCE
Prequalification Process	Conducted by the surety, a knowledgeable third party (extensive and ongoing)	Conducted usually by the general contractor, not a third party
Structure	3-party agreement (general contractor, subcontractor, and surety)	Two-party agreement (general contractor and insurer)
Regulation	Sureties are admitted and regulated by state insurance departments, regularly filing rates and financial information	May be written on non-admitted or surplus lines basis and, therefore, no recovery under state guarantee fund
Risk	Complete risk transfer from general contractor to surety, with first-dollar coverage	General contractor retains a portion of risk through high deductibles and co-payments
Payment Protection for Subcontractors and Suppliers	100% payment bond, with first-dollar payment benefit for subcontractors and suppliers	No payment benefit for subcontractors and suppliers
Subcontractor Default Management	If subcontractor defaults, surety completes, arranges for, or pays for subcontract completion up to bond amount	General contractor must manage subcontractor default, including completion of subcontractor's work
Payment of Losses	Surety pays losses after independent investigation	General contractor must pay losses and then submit documentation to recover from the insurer
Legal Precedents	Extensive history of case law/legal precedents	Little or no case law/legal precedents
Confidentiality of Subcontractor Information	Subcontractor has confidential and on-going relationship with surety	Many subcontractors are uncomfortable providing sensitive financial data to the general contractor (who might be their competitor bidding on the next project)
Premium	Cost is calculated based on contract amount, depending on size and type of project	Cost is calculated on general contractor's program costs and the deductibles and co-payments selected
Cancellation	The bonds cannot be cancelled	SDI can be cancelled by the insurer
Indemnity	Subcontractor is incented to perform by its indemnification obligation to the surety	SDI provides no such incentive other than for the subcontractor not to be sued by the insurer
Limits	Combined performance and payment bonds are equal to 200% of the contract amount	Policy subject to aggregate limit and per loss limit; sublimits also may apply, such as three or four times the subcontract value
Unseen Assistance	Sureties, with the expectation of no losses, provide assistance to bonded subcontractors through financing, engineering, and operational services	Insurers, with an expectation of losses, provide no assistance to subcontractors