

Working on a Subguard project: Loss of protection for Subcontractors©

**Susan L. McGreevy
Husch & Eppenberger LLC**

What is Subcontractor Default Insurance?

Subcontractor Default Insurance (“SDI”) is being marketed as an alternative to surety bonds. An owner who requires a general contractor to provide surety bonds is obtaining the commitment of a **third party** to be **100% responsible** in the event of a default by the **contractor** in **completing** the work and in **paying subcontractors**. An owner who allows a general contractor to provide SDI instead is obtaining commitments of **the general contractor and the third party** to each be **partially responsible** in the event of a default **by the subcontractor only** in completing its work. There is **no payment bond right** of subcontractors and suppliers.

How does it work?

As of the writing of this paper, only one company sells SDI. That is Zurich North American Insurance, and its product is called Subguard. In brief:

- Zurich agrees to insure the general contractor against losses arising out of the default of subcontractors. In this sense, it replaces performance bonds of subcontractors.
- The general contractor purchases a Subguard policy for a set dollar amount of policy limits during a set period of time (usually a calendar year).
- The general contractor and Zurich agree on the deductible that the general contractor must first pay out before the policy will cover claims, and that deductible is generally a large number – like \$250,000 or \$500,000 *per claim*.
- The general contractor and Zurich agree on a co-pay, which is the percentage of each dollar after the deductible that the insured will pay and Zurich will pay, and on a “Retention Aggregate,” which is the maximum amount the insured will have to pay for a claim arising during the policy period.
- The general contractor then “qualifies” the subcontractors, deciding who is a good risk to use on a project. How this is done is up to the general

- contractor, but generally involves getting financial statements and other confidential information from subs.
- The general contractor then “monitors” subcontractors during construction to avoid claims.
- In the event the general contractor declares a default, it can make a claim on the policy. Zurich agrees to start paying within 30 days of receipt of documentation to back up the claim, which means within 30 days of receipt of evidence that the general contractor has already paid out its deductible.
- No one other than the general contractor can make a claim, although it is possible that Zurich and the general contractor could agree to cover pass-through claims of major trade subcontractors. In such a case, the deductible and co-pay would have to be absorbed by that trade contractor, and the trade subcontractor would have to do the “qualification” of sub-subs. It is not clear how the cost of the premium would be shared among the general contractor and trade subcontractors.

How does this affect subcontractors?

There are reasons for subcontractors to be concerned about working on a project that uses SDI – both on the **qualification** end and the **claims** end.

Issues with qualification to participate in SDI project.

- ✓ *There is no incentive for a general contractor to not take the chance of using a new sub.* In fact, there is every motive to *not* use new subs or vendors. Since the GC must absorb any loss up to a large deductible (and there is a new deductible for each different subcontractor that is in default), there is no reason to try out a new sub.
- ✓ *All subs have to meet the GC’s “qualification” standards.* If the sub doesn’t meet those standards, the GC can still use it but the sub can’t participate in the Subguard program and so losses on the sub would not be insured.
- ✓ *The sub must spend the time and cost of meeting each GC’s “qualification” standards.* Each GC is free to set its own standards and procedures that a sub must comply with, and if a sub wants to be eligible to work on the SDI project, it has no choice but to comply. This could be requiring corporate documents, financial documents, meetings, filling out questionnaires, etc., none of which the sub gets compensated for doing.

- ✓ *The sub must give the GC sensitive financial information.* Any firm that has applied to a bank for a loan, or to a surety company for bond credit, understands how personal and sensitive the financial disclosures can be. While giving that information to banks and sureties is hard enough, now the sub is going to be giving it to another contractor, who in other circumstances might also be a competitor of the sub. Banks and sureties have clear legal requirements for assuring confidentiality of their customers' confidential information, because they deal with such issues every day. There are no particular standards that general contractors have to follow as to how they protect subcontractor financial information.

Issues with claims of non-payment in SDI project.

- ✓ *SDI is not a substitute for a payment bond.* If the general contractor becomes insolvent or just refuses to pay the subs, the subs have no recourse to the SDI policy. Subcontractors have no protection under SDI.
- ✓ *The only sub-subs and suppliers that might be paid by SDI are those that the GC chooses to include.* Because only the GC can make a claim, and it has to pay out the deductible and co-pay, it is not likely to include in a request to Zurich the bills of any sub or supplier to a defaulted sub, unless (1) the GC still needs that firm to complete its work, and therefore needs to get it paid; or (2) the firm has filed a lien and the owner is forcing the GC to get the lien satisfied and released.
- ✓ If the contractor goes into bankruptcy and cannot cover the deductible, the policy will never cover the rest of the loss, and the sub-subs and suppliers cannot recover.

How does this affect MBE/WBE/SDB's and other emerging subcontractors?

Zurich claims that, unlike a project using subcontractor bonds where Minority Business Enterprises/Women-Owned Business Enterprises/Disadvantaged Business Enterprises/Small Disadvantaged Businesses, etc. ("MBE's"), targets became "unfulfilled," if Subguard is used, the targets are fulfilled. There is nothing about the use of this SDI product that changes the issues or risks here.

It is no secret that "emerging" firms (i.e., ones without a lot of capital accumulated, a long track record, and/or seasoned personnel) have a harder time getting bonds, and that there are a disproportionate percent of MBE's among this group. It may be that by eliminating the requirement for surety bonds, MBE's who can't get such bonds will not be disqualified from participation

on a job. The presentations and Subguard policy, however, do not give facts to support this conclusion.

All the presentations say that one essential element of an effective, and cost-effective, SDI program is *exclusion* of subs who are not strong financially, who can't get bonds, or with whom a contractor hasn't worked much before. Thus, the less familiar and financially weaker firms (many MBE's) may not meet the "qualification" standards. If they are not allowed to participate in the SDI program, they will either have to produce surety bonds or be excluded from the program. Thus, the firms with the least chance of getting surety bonds are the only ones being required to obtain them. The irony of this should not go unnoticed by MBE firms and the organizations that advocate for them.

Further, on bonded projects, MBE's who could obtain a bond can generally be assured of the opportunity to bid. On an SDI project, they are at the mercy of the "qualification" process employed by the GC, and on the subjective opinions of the GC's personnel who are in charge of it.

How does this affect owners?

As noted above, a contractor who is insolvent and cannot meet its share of the deductible and co-pay will not be entitled to payment from Zurich. This leaves the owner with potential liens that can only be removed by payment directly from the owner – frequently requiring the owner to pay a second time for work for which it already paid the general contractor.

If the GC goes into bankruptcy, the owner might still be holding retainage on the GC, but the bankruptcy court may not allow the owner to use those funds to pay subs and suppliers, unless those claimants had lien rights. Those without liens have no rights and there may be nothing the owner can do to help them.

Even without a loss ever occurring, an owner on an SDI project has to anticipate a loss of competition among subcontractors, which generally leads to higher pricing. On bonded projects, a bid or offer from an unfamiliar sub or vendor can reduce an owner's over-all cost. On a Subguard project, that offer can't be considered if the offeror hasn't already gone through the qualification process, which often can't be done quickly enough.

And even without a loss or a bankruptcy that puts an owner's property at risk, it could make a difference to an owner to know that small businesses in its community have no right of recourse for payment. Many owners depend on good community relations for ongoing business success and don't want to see those marred by unpaid bills. The proponents of SDI make it appear that these supplier/sub-subcontractor claims can all be avoided merely by "good management." Yet construction is still a very high-risk business (according to Zurich, "subcontractors fail at the rate of 90,000 firms a year"), and there are many

times that all the “good management” in the world can’t prevent a loss. *Does the owner of the project want the publicity of unpaid sub-subcontractors?*

Susan L. McGreevy is a member of Husch & Eppenger, LLC, a Midwestern law firm. She is located in Kansas City and chairs the firm’s Construction Practice Group. She can be reached at 816/283-4699, or at susan.mcgreevy@husch.com.