Subguard Default Insurance vs. Traditional Performance and Payment Bonds for Subcontractors.

The following article is taken from excerpts of:

Understanding & Negotiating Construction Contracts – Kit Werremeyer

Subcontract Default Insurance: Its Use, Costs, Advantages, Disadvantages and Impact on Project Participants – Dennis Bausman


Typical AIA A201 contract language addressing the requirement of bonds reads as follows – “The Owner shall have the right to require the Contractor to furnish bonds covering faithful performance of the Contract and payment of obligations arising thereunder as stipulated in bidding requirements or specifically required in the Contract Documents on the date of execution of the Contract”. This language specifically addresses the requirements of the Contractor/Construction Manager by requiring Performance and Payment bonds. The ‘Performance’ bond is typically issued by a Surety Company or Bank for the benefit of the Owner by guaranteeing the Contractor/Construction Manager will complete the performance of the Contract. The Payment bond is also issued by a Surety Company, Bank, or other group such as a parent company guaranteeing the Subcontractors and suppliers will be paid for the materials and labor they furnish.

There is, however, another level of bonds that are utilized on construction projects – Subcontractor Performance and Payment Bonds. Contractors/Construction Managers often mistake bonding Subcontractors as either ‘double bonding’ or an unnecessary cost. The Contractor/Construction Manager’s bond protects the Owner from the Contractor/Construction Manager or Construction Manager’s performance default and protects the Subcontractors and suppliers from a payment default. The Contractor/Construction Manager should seek the same protection afforded the Owner for risks related to the subcontracted work. The Subcontractor bonds protect the Contractor/Construction Manager’s interest in the Subcontractor’s performance under its Subcontract with the Contractor/Construction Manager as well as the payment risk to the Subcontractor’s suppliers and any second-tier Subcontractors.

Some savvy Contractors/Construction Managers and Construction Managers often require ‘key’ Subcontractors to include payment and performance bonds as part of their base bid. Key Subcontractors are defined by these Contractors and Construction Managers based on the size of the Subcontract or the area of their work (i.e. building
envelope). Additional reasons for requiring Subcontractor bonds include critical path Subcontractors, projects with tight completions schedules, high liquidated damages, and Subcontractors not well known to the Contractor/Construction Manager. These performance and payment bonds work just like their counterparts for the Contractor/Construction Manager by guaranteeing the Subcontractor performs their obligations under the Subcontract with the Contractor/Construction Manager, and in the event of insolvency or other default, makes payments to lower tier Subcontractors and suppliers. Within this level of bonds, Contractors/Construction Managers can choose to require the Subcontractors to purchase traditional performance and payment bonds or the Contractor/Construction Manager can directly purchase Subcontractor Default Insurance (SDI). Zurich Insurance introduced Subcontractor Default Insurance in 1996 as Subguard®. It is the only insurer today of this type of insurance product and is often referred to by its trade name.

Comparison of Subguard to Traditional Surety Bonds

A Surety Bond is a Risk transfer contract between three parties – the Owner, the Contractor/Construction Manager, and a third party. The third party who provides the bond for a fee is typically a surety company, an insurance company, a bank, or the parent company of the Contractor/Construction Manager. For Subcontractor bonds, the three parties include the Contractor/Construction Manager, Subcontractor and the Surety.

Purpose – Surety bonds serve two primary purposes – prequalification and risk transfer. Sureties perform an extensive review of the Subcontractor’s financials as part of a prequalification process to assure the Subcontractor has the organizational and financial capability to perform its contracted obligations. In addition to prequalification, surety bonds provide protection in the event the Subcontractor is unable or unwilling to perform.

Contractor/Construction Manager Advantages
1. Independent, third party prequalification. Sureties are in a unique position to assess Subcontractor capability, capacity, and character and ultimately translate the Subcontractor’s financial performance data into project and aggregate bonding limits.

2. Performance Protections – in the event of Subcontractor default the surety has responsibility to remedy the default. The surety may find it appropriate to finance and/or supplement the defaulting Subcontractor, bring in a replacement Subcontractor, or negotiate a financial settlement with the Contractor/Construction Manager.

3. Payment Protection – A payment bond provides protection should a Subcontractor fail to pay Sub-subcontractors, suppliers, and/or labor. In the event of Subcontractor default, the surety assumes responsibility for dealing with unpaid creditors.
4. Coverage Limits – When performance and payment bonds are used together, combined coverage equals 200% of contract value – 100% of contract value for Contractor/Construction Manager performance and 100% for the Contractor/Construction Manager’s payment obligations.

5. First Dollar Coverage – In the event of Subcontractor default, bonds provide first dollar coverage for loss. There is no deductible for claims made against the bond.

6. Claim Service – Sureties have experienced risk management personnel that can respond to claims made against the bond and provide assistance to remedy Subcontractor default.

7. Ownership Commitment – Most sureties require personal and corporate indemnity. Assets of the firm and the personal assets of company ownership are pledged to the surety as a precondition for surety credit. Ownership has a vested interest in insuring operational performance and payment of the firm’s obligations on bonded projects. In other word, the indemnity arrangement provides incentive to construction executives to resolve project problems – an incentive that may not be present with the use of other risk transfer mechanisms.

Contractor/Construction Manager Concerns

1. Extended/delayed response – An often voiced criticism of Subcontractor bonds is the length of time required for the surety to initiate a remedy for the default of the Subcontractor. The surety is obligated to conduct a thorough investigation to determine the extent of the principal’s liability and the legitimacy of the default by developing a factual record. These investigations sometimes take weeks or months.

2. Narrow perspective of the Surety/ Lack of Control – Once the surety has completed its investigation it has the authority to decide how to remedy a Subcontractor default in keeping with the terms of its bond obligation. The Contractor/Construction Manager may be consulted, but the ultimate response is at the discretion of the surety.

Subguard

Definition – Two-party agreement between the Contractor/Construction Manager and the insurer that provides the Contractor/Construction Manager catastrophic insurance coverage for the cost of Subcontractor and supplier default. Unlike surety bonds, SDI is not first dollar coverage and policies are subject to high deductibles and a co-pay layer. With SDI the Contractor/Construction Manager, not the insurer, prequalifies the Subcontractors/suppliers and the Contractor/Construction Manager has a level of flexibility and control to respond to Subcontractors.
Purpose – Largely because of the concerns that various Contractors/Construction Managers had with surety response to Subcontractor default, Subguard was developed. One of Zurich’s primary objectives in the creation of SDI was to respond to the perceived shortcomings of Subcontractor surety bonds by providing the Contractor/Construction Manager greater control and flexibility in the management of Subcontractor default. In contracting, risk management insurance policy options typically permit the Contractor/Construction Manager to retain varying degrees of risk from 100% risk transfer to 100% risk retention.

The insurance options typically include:

a. pay a set premium and have all losses paid by the insurer
b. select a retrospectively rated program where the final premium is based upon losses incurred
c. choose a large deductible policy that only provides protection against catastrophic loss
d. develop a captive insurance program
e. self-insure against all losses

Prior to SDI, Contractors/Construction Managers essentially only had two risk management options –

a. 100% risk transfer with a bond
b. 100% risk retention for Subcontractor performance without a bond.

Subguard essentially filled the gap between bonding and not bonding.

Contractor/Construction Manager Advantages
Coverage Limit – Unlike a Subcontractor surety bond where coverage is limited to the penal sum, SDI coverage is not limited to the value of the Subcontract. In the event of damages or delays, the Contractor/Construction Manager may be reimbursed a greater amount than the amount if bonded.

Contractor/Construction Manager Control – With the SDI program, the Contractor/Construction Manager has control over which Subcontractors and suppliers are enrolled in the program. The SDI program also permits the Contractor/Construction Manager to exercise its judgment on how to remedy a Subcontractor or supplier default.

Consistency – SDI replaces a three party agreement that the Contractor/Construction Manager may have with a variety of sureties on multiple projects, with a first party relationship between the Contractor/Construction Manager and the insurer for all projects enrolled in the program. With Subguard there is one policy and one set of terms and conditions.

Cost Savings – The cost of a Subcontractor surety bond for a project is fixed and minimization of loss will not yield the Contractor/Construction Manager a rebate. With
Subguard, the Contractor/Construction Manager pays a fixed premium rate that is substantially below the cost of a bond, and should the Contractor/Construction Manager effectively manage program risk reducing or eliminating loss, the Contractor/Construction Manager can reap significant financial reward.

**Contractor/Construction Manager Disadvantages**

Financial Risk - SDI provides coverage for catastrophic loss and policies have substantial deductible and co-pay requirements for each occurrence. A Contractor/Construction Manager experiencing multiple defaults, involving several Subcontractors in the same policy year, could have financial exposure in the millions of dollars.

Increased Responsibility – The program places the responsibility and burden of managing Subcontractor selection, default declaration and remedy, and claim preparation.

Legal Precedence – Complicating the Contractor/Construction Manager’s decision process in management of program risk is the lack of legal certainty, or precedence, regarding enforcement of policy terms and conditions. There have been no known legal decisions regarding a policy dispute between a Contractor/Construction Manager and the insurer and little is known regarding the loss history of the program or of disputes arising from default declarations.

Single Insurer / Surplus Line – At present all SDI risk is aggregated in one insurer, since only one insurer offers the coverage (Zurich). Moreover, Subcontractor default insurance is sold on a surplus lines basis. Surplus lines insurance is coverage that is legally placed by an insurance company that is not admitted or authorized for that business in a jurisdiction. Surplus lines insurance usually must be placed through a producer or agent licensed to place such insurance.

**Cost**

For both the insurer and the Contractor/Construction Manager, the pricing structure for a Subguard program assumes the inevitability of Subcontractor default. Contractor/Construction Manager pricing of Subcontractor default insurance (SDI) involves three primary components:

1. Risk transfer premium paid to the insurer (Zurich)
2. The cost to manage Subcontractor / supplier prequalification and claims
3. A loss sensitive premium to build up a reserve fund for anticipated future claims
With each annual renewal the Contractor/Construction Manager pays the insurer a fixed risk transfer fee based upon the anticipated Subcontractor/supplier enrollment volume for that policy year. Its costs depends on a number of variables involved in the carrier’s evaluation of the firm including financial strength and stability, profitability and loss record as well as policy deductible, co-pay terms, and occurrence and aggregate limits. The risk transfer premium paid the insurer generally approximates $3.50/$1000 (or .35%) of Subcontract/purchase order enrollment value.

The Contractor/Construction Manager’s cost to administer the program, perform the prequalification of Subcontractor and suppliers, and manage program claims is a program cost. However, Contractor/Construction Manager cost is often hard to quantify because often a portion, if not all, of the program duties are performed by existing management and staff. In addition, establishing an appropriate loss sensitive premium for the Contractor/Construction Manager’s reserve pool is often problematic because of the lack of adequate loss history.

Zurich closely guards information regarding loss history of the Subguard program. Even if it did publish claims and program losses to date representation of program risk would be incomplete because of the relative short history of the program. Seven years after the launch of the program there were approximately 300 claims and fewer than 15 of those were greater than the Contractor/Construction Manager’s deductible. Zurich’s risk envelope can extend 10 years after substantial completion of the project and adequate data necessary to validate the risk of the program may not be apparent for years or even decades.

Finally, SDI is normally priced to the project owner at, or slightly less, than a surety bond which is normally 1.00% to 1.25% of the Subcontractor/supplier value. This would provide .65% to .90% of subcontract value for program administration and claims — or possible cost savings to the Contractor/Construction Manager if losses can be contained. A Contractor/Construction Manager may or may not make a project owner aware of the difference between the Contractor/Construction Manager’s pricing structure for SDI and the project cost charged to the project owner. Regardless, the owner’s cost will include the Contractor/Construction Manager’s assumptions for the costs of program administration and claims management.

Subcontractor/Supplier Perspective
One positive from the Subcontractor/supplier’s perspective is enrollment on a Subguard project may not tap their available bonding capacity or require personal indemnity. However, with SDI the Sub-subcontractor/supplier lacks payment protection from the insurer and can be subjected to invasive Contractor/Construction Manager prequalification process.

Payment Protection – Unlike a Subcontractor payment bond, the SDI policy does not provide payment protection for 2nd tier Subcontractors or supplier. In addition, if the
Contractor/Construction Manager becomes insolvent, or just refuses to pay, an enrolled Subcontractor has no recourse against Subguard.

Prequalification process – Prior to enrollment in the SDI program a Subcontractor must submit to the Contractor/Construction Manager’s prequalification process for each and every Contractor/Construction Manager that utilized SDI. There are no universal industry standards and the process varies from Contractor/Construction Manager to Contractor/Construction Manager. It can require the Subcontractor to share sensitive information that may be misinterpreted, adversely impact its competitive position, and/or damage the Subcontractor’s reputation if divulged.

Unwarranted Default – With SDI, the Contractor/Construction Manager can unilaterally declare a Subcontractor in default. There is no independent third party assessment of cause or remedy. The Contractor/Construction Manager can declare a Subcontractor in default, implement what it deems to be appropriate action, and assess the incurred cost against the Subcontractor.

Subcontractor Selection Incentives – There is an incentive with an SDI program to use Subcontractors already enrolled in the program because each new Subcontractor added in a policy year has a separate deductible. A Subcontractor already enrolled in the program has a competitive advantage.

Owner Perspective
Many owners do not fully understand Subcontractor default insurance and are unable to compare this insurance product with surety bonds. However, those with at least some rudimentary understanding or experience view the product with mixed opinion and concern.

- Owners are told by their Contractor/Construction Manager that SDI gives the Contractor/Construction Manager greater flexibility and control to more effectively deal with poor Subcontractor performance and Subcontractor default. They are advised that this will help ensure that their project will be completed on time and within budget.
- Contractors/Construction Managers also state the Owner will also directly or indirectly benefit from the higher per loss limits afforded by SDI.
- Contractors/Construction Managers also tell their Owners that SDI broadens the pool of Subcontractors by permitting the use of small local firms, minority Subcontractors, and other firms that may not have the bonding capacity.

Proponents of Subcontractor surety bonds submit that bonds ensure better quality Subcontractors for their projects and higher coverage limits on larger work. In addition, supporters of Subcontractor bonds claim the project will be priced more competitively because binds from unfamiliar Subcontractors/vendors will increase competition.
Most Owners see no significant difference in cost between Subcontractor surety bonds and SDI and some question why they don’t share in the cost savings should the project have a good loss history.

Another concern with using SDI on federally funded work is compliance with the False Claims Act. With SDI the Contractor/Construction Manager typically charges the Owner (government) more than its direct cost paid to the insurer for program coverage. This may be considered a violation of certain federal statutes, such as the False Claims Act.