Subguard/Subcontractor Default Insurance

INTRODUCTION

What do you do when the general contractor (GC) on a project you were just asked to bid calls for very detailed financial information to qualify your company under its Subguard policy? Your first response may be, "What is Subguard and why does this contractor need all of my detailed financial information?"

Subguard is a trademarked name for a Subcontractor Default Insurance (SDI) program marketed by Zurich North American Insurance Company. Subguard and Subcontractor Default Insurance are terms that can often be used interchangeably by many in the insurance industry and are becoming more widely used in the construction industry.

These programs are touted by the insurance companies to large general contractors, at-risk construction managers and design-build firms as an attractive alternate to the traditional surety programs. For purposes of this bulletin, however, we will refer to the purchaser as the "general contractor."

The programs started around 1996 at a time when the surety market had contracted and parties were looking for other options to provide protection from subcontractor default. Under SDI, the general contractor, construction manager or design-build firm purchases the policy directly from the insurance company. The two-party agreement is solely between the insurance company and the purchaser." In contrast to the historical surety programs, SDI is intended to shift a large portion of the risk associated with subcontractor default from purchaser the insurance company by means of the issued policy.

These programs vary between the insurance carriers but in general are typically reserved for large construction companies that subcontract at least $75 million or more of work on an annual basis. Moreover, they are used in the private contracting world due to the federal Miller Act and various state statutes applicable to public construction projects. Public projects will still typically be subject to traditional surety bonding.

SUBGUARD VS. PERFORMANCE AND/OR PAYMENT BONDS

Subguard policies differ significantly from the traditional Performance and/or Payment Bonds issued by the surety companies. Under a Performance and/or Payment Bond, the issuing

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surety company guarantees to one or more parties the performance or payment of another party under a construction contract.

To the extent that a subcontractor or vendor who has issued a Performance Bond and/or Payment Bond fails to perform or defaults under the contract, the surety company has the obligation to complete the work under the Performance Bond and to pay any outstanding invoices or payment obligations under the Payment Bond. The surety essentially steps into the place of the defaulting contractor and will either perform the work or subcontract with others to perform the work. As a result of this obligation, the surety will be entitled to any remaining payments due under the contract to assist in offsetting its cost. To the extent the remaining amount left under the contract is insufficient to address the completion of the project, the surety company will seek to enforce the indemnity or guaranty agreement that it received from the subcontractor for whom the bond was issued.

In contrast to a surety program, under Subcontractor Default Insurance the coverage provided is subject to a large deductible which could be $500,000 to $1,000,000 or more. Additionally, since it is the general contractor, construction manager or design-build firm that has the obligation under the large deductible, they are the responsible party to pre-qualify the subcontractors they elect to cover under the program. As a result, the general contractor, construction manager or design build firm will implement a detailed qualification process in order to screen subcontractors for coverage and ultimately the decision to accept or deny them under the policy will typically be theirs.

Since the general contractor has deductible liability, they are viewed as being in the best position to evaluate and address very quickly subcontractor failures. Under the traditional surety relationship, the surety is responsible for reviewing the creditworthiness of the contractor in deciding whether or not to issue a bond.

SUBGUARD ADVANTAGES/ DISADVANTAGES

One key advantage to the general contractor under Subguard is that it can take over for the defaulting subcontractor in a short period of time with coverage provided for direct and indirect costs resulting from the subcontractor's default. The general contractor is not required to finance the completion of the job on an interim basis as they would under a surety bond situation since payments made from the insurance company under a valid claim are typically made within thirty (30) days of providing documentation of the loss. In contrast, the surety will undertake investigation that could add months to the project as they will be slow to act while they perform a full investigation. This creates additional liability on the general contractor as they often cannot wait for an answer and must maintain job progress.

SDI is advantageous to the subcontractor since it preserves the subcontractor's bonding line by removing the need to issue a bond. As a result of the last downturn in the construction industry, the surety landscape further contracted and fewer companies are writing surety bonds today. Therefore, the availability of bonding lines has been diminished, leading to more stringent requirements from the remaining surety companies. In addition, bonding lines often require a broad indemnity agreement and/or a personal guaranty from the

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shareholder(s) or owner(s) of a contractor or some other form of pledged collateral. Since Subguard is a policy procured by the general contractor, there is no cost to the subcontractor nor is any personal guaranty or other security required to be provided.

However, it is important to note that the Subguard carrier only has an obligation to the insured (the general contractor) and there is no independent obligation to the subcontractor. If a general contractor fails financially, neither the owner nor the subcontractors will be protected or covered by the policy. Under such a scenario the subcontractor would not have a claim against the insurance company while in the surety situation they would have a claim against a bond issued by the general.

From the project owner's viewpoint, lenders typically look favorably on projects that have a Subguard policy in place as there is less concern for defaulting contractors and this may lead to quicker loan approval. Since the work is funded by the insurance company, the project is able to move forward with less of an impact to the schedule.

Further, while a surety bond typically provides for one year of construction defect coverage, SDI often covers latent defects for up to 10 years. With Subguard in place on a project, the general contractor will have an easier time securing a performance bond from their surety if one is requested by the owner. Moreover, since the bond and insurance costs are passed on to the owner through the cost of the work, the cost for the SDI is less than buying individual bonds from each of the subcontractors as they are often covered under one policy.

COSTS

The typical SDI premium can run from .4% to upwards of just over 1%, depending largely upon the selected deductible and other factors related to the general contractor's qualification procedures. The higher the deductible the lower the policy cost. Under a high deductible policy that includes loss fund or retrospective premiums, the GCs can often pass through to the owner the full cost of the policy with a potential return of premium if no claims are made under the policy. Since the general contractor is driving the pre-qualification process and the management of the subcontractors, if managed properly, this can often lead to additional profit on a job for a general contractor which is a large reason these programs are becoming more attractive.

An additional attraction to the general contracting community is that Subguard will cover costs of correcting defective work, delay costs, payment to suppliers and vendors, delay costs, liquidated damages, extended general conditions as well as other costs associated with a subcontractor's default. Some of these costs would not typically be covered under the traditional surety program.

This bulletin is not intended to be legal advice. A person should seek local counsel for specific information regarding the information found in this bulletin.

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