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Managing the Risk of Subcontractor Default

Subcontract Bonds and Other Alternatives

By

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Managing the Risk of Subcontractor Defaults
Subcontract Bonds and Other Alternatives[1]

When a general contractor enters into a construction contract with an owner, it explicitly assumes the risk of timely and complete performance of the work. It will often furnish bonds guaranteeing that performance. The general contractor may then subcontract a substantial percentage[2] of the work to various subcontractors in the particular trades. The success or failure, and the profit or loss, on a project may ultimately depend on whether those subcontractors timely and properly perform their work. Some don't. Some fail.

Most general contractors have developed practices and procedures to screen out unqualified subcontractors, monitor subcontractor performance, and protect against subcontractor failure. Some of the common practices used by general contractors are worth noting:

- Prequalification of subcontractors, through reference checking and select bid lists
- Caution when dealing with high percentage bid spreads
- Verification of subcontract scope
- Use of well written subcontracts and purchase orders
- Requirements for adequate insurance coverages
- Monitoring of payments to the subcontractors' vendors through periodic lien releases, joint checks, and bills paid affidavits
- Contractual retainage on progress payments
- Good safety programs
- Attention to draw schedules of values to avoid unbalanced or front end loaded payment terms
- Management of the subcontract draw process through careful evaluation of progress, percentage of completion, and remaining cost to complete

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[1] This paper was first prepared and presented to the State Bar of Texas Construction Law Section's 20th Annual Construction Law Conference. It was updated over time to address new issues and for various owner, contractor, and subcontractor trade groups.

[2] The percentage of subcontracting varies by company and type of work. A utility contractor may self perform all of its work, subcontracting nothing. A typical commercial building contractor is likely to subcontract 75-80% or more of the work on a project, perhaps everything other than project management.

- Management and supervision of subcontractors in the field
- Schedule control
- Sensitivity to signs of subcontractor failure and a commitment to deal with or avoid it before it impacts a project

These are risk minimization/avoidance practices and procedures that can be employed by the general contractor with its own personnel. In addition, there are several risk transfer/risk minimization products and services available through third parties to further protect against the consequences of subcontractor failure. This paper will focus on two risk transfer products and two third party risk management services that are available to general contractors. The products, underwritten by insurance companies, are subcontract bonds and subcontractor default insurance ("SDI"). The services, provided by accountants, consultants, and third party providers are outsourced subcontractor prequalification and services variously called "third party funds control," "funds disbursement," "funds administration," or "construction escrow services."[3]

Subcontract Bonds

The bonding of subcontracts has become a common practice in the commercial construction industry. In many cases, sureties are requiring their general contractor accounts to require bonds from major subcontractors. Many general contractors simply consider it prudent business policy to bond all subcontracts above a threshold dollar value. Owners and developers are requiring that major subcontracts be bonded, so as to assure higher quality of construction, whether or not the general contractor is bonded.

The results of surveys conducted by the American Subcontractors Association demonstrate that subcontract bonding is virtually a fact of life in the commercial construction industry. In one survey, eighty percent of the responding specialty trade contractors stated that they had provided surety bonds as subcontractors on projects.[4]

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3 Disclosure: I have tried to be unbiased and objective in the comparison of those two products. While I am an officer in a surety company, and obviously believe in the value of surety bonds, I am also the President of a company that provides fee-based services to Subcontractor Default Insurance users. I also think SDI is a fine product. Each of these provides a risk management tool. Each has its unique attributes. There is room for both in the general contractors' tool chest of risk management products. The other two services covered in this paper, funds disbursement services and subcontractor prequalification, are natural add-ons to Subcontractor Default Insurance, or to any subcontract risk management program. The references in this paper to SureTec's services are merely those with which I am most familiar and believe to be representative of the services available in the market. There are many well qualified companies who provide these services.

4 American Subcontractors Association, Survey of Construction Subcontractors on Experience with Surety Bonding (July 1988).

When a contract is "bonded," the subcontractor, as principal, and a corporate surety, as surety, obligate themselves to a general contractor, guaranteeing that an underlying construction contract will be performed as set out in that subcontract. A "subcontract performance bond" provides assurance to the general contractor that the contract will be completed for the agreed-upon contract sum, while the laborers, materialmen and subcontractors of the contractor or subcontractor look to the "payment bond" for assurance that their request for payment will be satisfied.

Subcontract bonds are typically written for 100% of the subcontract amounts…coverage equal to 100% of the subcontract amount for the performance obligations and coverage equal to 100% of the subcontract amount for the payment obligations. Both bonds provide “first dollar coverage;” i.e., do not have deductibles of co-pay provisions.

The premium for performance bonds will depend on the nature of the work, length of the project, and the financial strength of the subcontractor. Rates of 1% to 2 ½% are common, with 1 ½ % as a common rate used by estimators in projecting the costs of subcontract bonds for a project. Because a sliding scale is used, the premiums for smaller bonds are greater, often toward the 2 ½% end of the range, with larger bonds averaging out to 1% or less. There is usually no additional premium for the payment bond. A payment bond alone is slightly less than the premium for a performance bond or performance and payment bond. Bid bonds usually are issued with no charge or only a minimal charge. Premiums are generally surcharged at a slightly higher rate for design-build subcontracts and projects of greater than two year duration.

By bonding its subcontractors, the general's own credit standing with his surety will often be improved due to the transfer of the risks to the subcontractor's surety.

The ability of a subcontractor to furnish bonds is a form of prequalification. In order for the subcontractor to provide those bonds, it will have gone through the surety’s reference checking and financial review.

By virtue of the indemnity agreement typically executed by the owners of the subcontracting firm in favor of the subcontract surety, the general contractor gains assurance that the individual owners of the subcontracting firm will stand behind their company, if necessary, with their personal assets. This is not an inconsequential factor. Knowing that the subcontractor’s owners will devote their primary efforts to saving the bonded jobs when problems develop, is significant.

The bonds themselves are usually written on the same types of bond forms that are furnished at the general contractor-owner level, with one key difference. In most states, the rights and liabilities of the parties to payment bonds furnished by a

general or prime contract are, to a great extent, determined by statute.[5] These statutes prescribe various notice requirements, statutes of limitation, and the form and manner in which claims may be made against the bond furnished to the owner by the general contractor. Where the general contractor's bond may governed by one or more of these statutes, the actual content of the bond form tends to become less significant, since the bond may be held to incorporate the terms of a statute pursuant to which it is written.

In contrast to those prime contract bonds that are statutorily prescribed, subcontract bonds are simply common law obligations subject to general rules of contract law and construction.[6] This absence of statutory regulation results in a wide variation in the types of bonds required of, or provided by, subcontractors and their sureties. The particular bond form that is employed will substantially affect the allocation of risk between the general contractor/obligee, the surety, and the subcontractor/principal.

The rights and liabilities of the obligee or other claimants under a bond will be determined in accordance with the written terms of that bond.

There are several types of bond forms encountered in subcontract bonding transactions. These forms include separate payment and performance bonds, and combined payment and performance bonds. Whether separate or combined, the forms of payment bond further fall into two categories; those that provide direct action to third party claimants and those which indemnify only the named obligee. They are as varied in terms and content as the imaginations and drafting skills of the general contractors who require them and the sureties who execute them. While it would be simple enough to suggest that separate bonds always be used, and that the payment bond always be written with the suppliers as intended obligees, there are occasions when more restrictive bond forms are appropriate. The following discussion will guide you through some of the issued to be encountered.

Separate Payment and Performance Bonds

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[5] For example, in Texas, bonds furnished by prime contractors on state, local and other non-federal public works are required by, and governed by Chapter 2253 of the Government Code. Bonds furnished by prime contractors on federal projects are governed by the Miller Act, 40 U.S.C. § 3131 *et. seq.* In Texas, there is no statutory requirement that prime or "original" contractors on private construction projects furnish bonds, but those payment bonds that are furnished will generally be governed by Subchapter I of Chapter 53 of the Texas Property Code.

[6] In Anahuac v. Wilkes, 622 S.W.2d 634 (Tex. Civ. App.-- Austin, 1981 no writ), the court held that a subcontract bond was not governed by the Texas private works bond statutes. In that case, the claimants on the payment bond had perfected their claims in accordance with the terms of a bond which apparently contained more liberal terms than the requirements of the Property Code. The surety argued that the notice and filing requirements of the Act should govern. The court rejected this argument, stating that the bond did not appear to have been posted in compliance with the private works bond statute, so that the terms of the payment bond governed, and the surety was obligated to pay the claims.

The issuance of two separate bonds, one to guarantee the subcontractor's performance obligations, and one to guarantee the payment by the subcontractor of its sub-subcontractors and suppliers, is perhaps the most frequently encountered method to bond subcontracts. Likewise, it is the most frequently encountered method in the general contractor bonding context. Separate payment and performance bonds maximize coverage for both the obligee-general contractor, as well as third-party claimants since they provide two penal sums, i.e. two separate funds for recovery. The general contractor-obligee looks to the performance bond, and usually, third-party subcontractors and suppliers look to the payment bond. AIA Documents A-311 (1970 version) and A-312 (1984 version), and surety department variations thereof, are often used as separate subcontract performance and payment bonds. Many general contractors require subcontract bonds to be issued on forms developed by the general contractors. Those tend, obviously, to favor the general contractor. Many sureties use their own forms, which tend to restrict some of the coverages provided.

General contractors sometimes lose sight of the fact that the terms of a bond form may eliminate some otherwise qualified subcontractors from being able to bond. Consider, for example, a common provision in a general contractor's subcontract bond form…a longer limitation provision or no limitation on time to file suit at all. A particular subcontractor may qualify for a $1 million roofing subcontract bond, but not if the subcontractor's liability is co-extensive with the roofing material supplier's 20 year roof warranty. A contractual limitation provision in the bond to perhaps two years makes the difference between the subcontractor qualifying for the bond or not. If the general contractor holds to requiring a bond form with no limitation, it loses the bid of that roofer. The question becomes…."Did we really need the roofer to be jointly liable with a Fortune 1000 material supplier on a membrane warranty for years 2-20? Was blindly adhering to our requirement of no time limitation in the bond really worth the difference in the next higher price that we had to pay?" Of course, if having the bond protection for the longer period is important, the general contractor should look for a subcontractor that can qualify for such bond credit.

Combined Payment and Performance Bonds

Payment and performance bonds may be combined in a single instrument. However, as stated above, it is usually to the general contractor's advantage to require separate performance and payment bonds in order to assure protection for the general contractor and creditors sufficient to complete performance and pay unpaid subcontractors or suppliers in the event of default. Separate payment and performance bonds eliminate the problem of deciding who should be paid first, i.e. the obligee or the claimant, by providing two penal sums. The general rule is that where the payment and performance obligations of the surety are combined in a single bond, the performance obligation may take priority and a third-party claimant, in some situations, may not be able to maintain a separate suit on the bond.[7] An

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[7] See, *Daniel-Morris Company, Inc. v. Glens Falls Indemnity Company*, 126 N.E.2d 750 (N.Y. 1955).

obligee who is being provided with this type of bond form should review it carefully and, if possible, insist on a separate payment and performance bond to more adequately protect its rights.

Indemnity Bonds

Under this bond form (which may be in the form of a separate payment bond form, or in a combined form), unpaid suppliers and sub-subcontractors of the bonded subcontractor have no direct claim against the subcontractor's surety. Instead, these claimants are relegated to filing their claims against the general contractor, its bonding company and/or the owner under the Miller Act or applicable state law. The obligation of the subcontractor's surety is limited to "indemnifying" or "paying back" the general contractor only for such losses as the general contractor may sustain by virtue of those claims. Liability to third parties, other than the named obligee, is usually expressly excluded.

When a subcontract indemnity bond is compared with the typical performance bond, such as the AIA performance bond, it is obvious that the performance exposure of the subcontract bond surety under an indemnity bond is relatively limited in certain respects. Under the AIA performance bond, the surety is obligated to remedy its principal's default or otherwise arrange for the completion of its principal's work. Although the general contractor would prefer this bond in the event of its subcontractor's default, there are circumstances where a subcontractor may only be able to qualify for the somewhat more restrictive indemnity bond.

Advantage of Subcontract Bonding to the Subcontractor

The subcontractor who has the ability to bond sets itself apart as a pre-qualified participant in the construction process. The availability of bond credit shows the general contractor that the subcontractor has been judged by third party underwriters to have the character, capacity and capital to perform its subcontract obligations. The ability to pre-qualify has competitive advantages for the subcontractor.

Additionally, the bonded subcontractor may be given greater leeway in billing, have less retainage withheld, and may be subjected to far less paperwork with respect to proof of payment to lower tier subcontractors and suppliers.

Subcontractors benefit, in terms of fewer schedule disruptions and claims, from working alongside other qualified bondable subcontractors.

Advantage of Subcontract Bonding to the Project Owner

While the project owner may be protected against the general contractor’s financial failure by the general contractor’s bonds, any project is enhanced when all of the participants are pre-qualified, financially stable, and backed by corporate

sureties. Quality, safety, schedule adherence, and performance during contractual warranty periods are all enhanced.

Advantages of Subcontract Bonding to General Contractors

Most of the advantage of subcontract bonding are obvious: professional third party prequalification of subcontractors, first dollar coverage against loss, coverage equal to 200% of the subcontract amount, the comfort that provides to the general's surety, the surety's claim services, and a place to point unpaid suppliers when they come knocking on the general contractor's door for payment.

One of the most significant advantages of subcontract bonding, not often appreciated, is that most subcontractors' individual owners have to personally guarantee to their sureties that the work will be performed and bills paid. Ocassionally, they will post collateral or have the indemnity of third parties as well. The fact that the individual owners are personally committed will usually insure that bonded jobs are taken care of before unbonded jobs, that bills on bonded jobs are paid before bills on unbonded jobs, and that the individual owners have a vested interest in favoring the bonded project over all others.

Dual Obligee Riders

As its name implies, a dual obligee rider is an attachment to a bond which designates a second obligee as a beneficiary under it. By naming a dual obligee, the surety assumes an additional obligation to a separate entity which is not a party to the bonded subcontract, but which has an interest in the project. These types of riders are occasionally required by project owners who want the protection of the subcontract bonds in the event of a general contractor default.

As may be expected, the addition of the owner as an obligee under a subcontract bond creates a new set of risks and complexities for the parties involved. The obvious disadvantage for the subcontractor-principal is that the subcontractor now has another party with a potential remedy against him in the event that party becomes dissatisfied with the subcontractor's performance. Depending upon the language of the rider, the subcontractor may have assumed obligations to the owner despite the fact that the owner is not a party to the subcontract. Thus, the subcontractor may lose the "buffer" of the general contractor, who, in the normal situation, would stand between the disgruntled owner and the subcontractor in the usual chain of relationships on a construction project. Worse yet, and absent appropriate savings language, the subcontractor and its surety may find themselves obligated to an owner notwithstanding a breach of contract by the general contractor.

Occasionally, a general contractor may attempt to bond all of its subcontractors, name the owner as dual obligee, and in that manner satisfy its own bonding requirements under the general contract. Assuming that each respective

subcontractor's surety would agree to such an arrangement,[8] and that the owner would accept such arrangement,[9] most state's public works statutes would not allow this arrangement to substitute for a prime contractor's bonds. The stacking of subcontract bonds in this fashion would not, satisfy most states' "Little Miller Act Laws."

Subcontractor Default Insurance ("SDI")[10]

Subcontractor Default Insurance ("SDI") is an insurance policy that provides first party coverage to general contractors for the direct and indirect costs of subcontractor defaults. Some general contractors use SDI in lieu of requiring bonds from subcontractors. Some general contractors use both SDI and bonds (although not at the same time with the same subcontractors) as risk shifting tools. With high deductibles and co-pay provisions, SDI is not "first dollar" coverage for subcontractor defaults. Rather, it is a type of self insurance which provides catastrophic coverage for subcontractor defaults. It is generally not sold to contractors with annual volumes of less than $50 million. It is a product best suited to larger contractors with proven discipline in their careful selection and management of their subcontract risks.

Subcontractor Default Insurance was first introduced in the mid 1990's. Currently, Zurich North America, XL Insurance, and Construction Risk Underwriters (through Catlin Insurance and Arch Insurance), and are offering SDI products.

An increasing number of large general contractors, construction managers and design build firms have purchased SDI. While hard data on the utilization of SDI is not generally available, my informal survey suggests that the vast majority of the top 100 ENR General Contractors are using some form of SDI. While SDI was first touted as being only for very large general contractors, the product has definitely moved to the middle market. In some markets, the use of SDI is even more prevalent. At least 8 of the 10 largest commercial building contractors in Texas are using SDI on some or all of their projects. It is speculated that, based on volume of contract exposure covered, SDI underwriters, if they were a surety, would rank in the top three or four surety underwriters in the country. While once considered by some critiques in the competing surety industry as a "flawed product" which would not last, SDI has gained traction and considerable acceptance among the largest contractors in the U.S.

Coverage and Terms

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[8] Sureties are reluctant to bond subcontractors to unbonded prime contractors. Cynics will suggest that the reason is that those sureties would generally like to see more premiums generated. On the contrary, the subcontractor working for an unbonded general contractor has assumed a credit risk. If the general contractor were to default and fail to pay the bonded subcontractor, the subcontractor or its surety would be required, at a minimum, to pay that subcontractor's suppliers for work performed . . . and without compensation.

[9] That still leaves the general contractor's obligations unbonded and the potential for all of those subcontractors and their sureties not to be liable if the general contractor defaults and does not pay them.

[10] Many thanks to Steve Warnick, formerly of Austin Commercial, LP, a user of both subcontract bonds and SDI, for his help with this aspect of this paper.

SDI Policy limits and deductibles will vary from policy to policy based on the general contractor's risk appetite. Policy terms are occasionally negotiated by the sophisticated general contractors that purchase it. Thus, it is hard to make too many generalizations about its coverage policy terms. Anyone interested in purchasing it would be well advised to use an insurance broker who is very familiar with the product. Any practitioner involved in negotiating or interpreting policy terms should refer to the policy itself. Those caveats aside, the following are the policy terms most often encountered:

- SDI is first party insurance indemnification form. That is, it is purchased by the general contractor. The general contractor is the insured.

- SDI is a two party agreement between the general contractor and the insurance company. The subcontractors are not party to the agreement.

- The project owner can, by endorsement, be named as a scheduled entity to a financial interest (loss payee) endorsement.

- The policy is triggered by a subcontractor default in accordance with the subcontract terms. If it is determined that the default was improper, coverage would cease and payments previously made by the carrier would have to be returned.

- The general contractor is required to prove a default through the filing of a "proof of loss." The SDI carrier is obligated to indemnify the general contractor for a loss within thirty days after the carrier receives a properly documented proof of loss.

- The SDI carrier has no "duty to defend" in this contract of indemnification.

- Typically, all un-bonded subcontractors on a project are covered, although there are provisions to carve out certain subs or to limit the aggregate exposure to a single subcontractor. Purchase orders can also be covered by agreement. Thus, the general contractor is responsible for subcontractor prequalification. The insurance company does not prequalify the subcontractors. In essences, it prequalifies the general contractor's prequalification process.

- SDI covers the expenses incurred by the general contractor in fulfilling a defaulting subcontractor's obligations, the cost of correcting defective or non-conforming work, professional costs incurred as a result of the default, and certain indirect costs associated with subcontractor default, such as delay damages, acceleration costs of a critical path subcontractor that is adversely impacted by the defaulted subcontractor, and extended overhead costs incurred by the general contractor (which are considered an indirect expense and subject to a sub-limit).

- Both performance and payment related costs, including the cost of removing liens is included. The policies do not, however, provide direct payment coverage to the subcontractor's suppliers and sub-subcontractors. In this respect, it is like the indemnity bond discussed above.

- Coverage does not cease at policy expiration. The SDI policy will generally respond through the statute of repose or ten years, whichever is earlier. It is not a claims made policy. The policy year in which the subcontract is executed dictates the year in which a default is covered.

- For coverage to be effected a subcontractor must be given a formal written notice of default in accordance with the subcontract terms, but the subcontractor does not necessarily have to be terminated.

- There are nine exclusions based on misrepresentation, fraud (including the filing of a false claim), defaults occurring prior to the policy period, material breach of warranty by the general contractor, subcontracts acquired from other entities, nuclear risks, war risks, losses arising out of the providing of professional services by the insured, and loss resulting directly or indirectly in bodily injury.

- Losses which exceed deductibles are pursued in subrogation by the SDI carrier. If any recovery is made, the insurance company is made whole first. Any recovery after that will be shared with the general contractor as outlined in applicable terms of the policy.

- Existing subcontract balances must be exhausted before the indemnification can take place.

- Generally written as separate annual policies, over say, a three year program, or as a rolling program based on volume, without reference to a time frame.

- Subject to a deductible per default of $500,000 to 1,000,000 (although that amount may be negotiated up or down depending on the structure and size of the program and the general contractor's appetite for risk). The SDI underwriter definitely wants the general contractor to have "skin in the game,"

- Subject to a co-pay of 20% of a specified layer over the deductible…to keep the skin in the game.

- Written with varying one year and three year aggregate limits, but generally not available for more than what a general contractor is willing to assume and remain in business due to a catastrophic loss or aggregation of losses in an annual policy period. Generally not available for more than $75 million per default and $225 million in the aggregate for all losses in a given year. This is

significant when compared to the coverages of subcontract bonds. Subcontract bonds provide coverage equal to 100% of the subcontract amount for performance issues and 100% of the subcontract amount for payment bond issues for each subcontract. On a $50 million project that is 80% bonded, that's $40 million in performance coverage and $40 million in payment coverage for that one project. For an SDI user, the total available coverage for that job and all other jobs that general contractor has might only be $50 million in total.[11] Absent dedicated limits for a specific project, (which appears to be available, at a price, from the SDI insurer) the sureties for some general contractors are concerned that the SDI coverage is insufficient to allow those sureties to extend the amounts of surety credit those general contractors require.

- SDI coverage is not subject to a sub-limit per subcontractor. Thus, a critical $2 million subcontract in default that requires considerable re-work, and higher cost for re-procurement complete in an accelerated fashion, might be covered (subject to deductibles and co-pay) for an ultimate $3.5 million loss, whereas only $2 million in subcontract bond coverage would have been available had the same subcontractor been bonded.

- SDI pricing may vary depending on the general contractor, volume of subcontracted work, and market factors, but usually consists of two components, the risk transfer premium which covers the risk transfer to the carrier…i.e., the "cost of the 'catastrophe' insurance," and an additional lost sensitive premium, which together constitute the amount typically charged back by the general contractor to an owner or included as a cost of the work. The difference between the combined premiums and the risk transfer premium may be handled in different way, usually in some form of loss sensitive structure, much the same as any general contractor would benefit from savings, retro rating, or rebates on its other insurance products.

One Big Reason General Contractors Use SDI

An example of the pricing and risk/reward benefits of SDI will illustrate why this product has gained acceptance among so many large general contractors. Consider a general contractor with $200 million in annual volume, of which 80% or $160 million is subcontracted. That general contractor will pass on an SDI combined premium to its project owners in an amount competitive with subcontract bonding, say 1.5%, or $2,400,000. Assume a risk transfer premium of 0.4% for risk transfer, or $640,000. Assume another 0.2%, or $320,000, in program costs to the general contractor for administering its SDI program and prequalification efforts. If the general contractor is good at prequalification and risk management, and has no losses, the general

[11] Limits are, however, reinstated annually and a subcontractor default is deemed to be one loss regardless of the number of subcontracts. So, two or three policies may be triggered based on the subcontract date as mentioned above.

contractor's SDI loss sensitive program may benefit by as much as $ 1,440,000 ($2,400,000 - $640,000 - $320,000). That amounts to 0.7% of its gross volume for that year. To a general contractor working in an industry where 3% gross margins are already considered good, this is a real incentive to prequalify and manage subcontract risks.

Of course, the foregoing assumes no defaults. All it would take is a default of one mechanical contractor on one of the general contractor's many projects to wipe out all of the favorable loss experience. For this reason, most SDI contractors use those funds as a reserve fund against loss, building up a substantial reserve over time. And, while critiques of SDI once predicted that general contractors would load up on low bid unqualified subcontractors because they had insurance, the opposite has proven to be true. General contractors using SDI have become more risk adverse than their counterparts using bonds. They challenge themselves to earn back as much of that experience premium as they can.

The Subcontractors View of SDI

Subcontractors may have mixed reactions to working on SDI project. On one hand, they are not required to use their available surety credit. That means that the owners of the subcontracting entity may not have personal liability as they would to their surety. It also means that scarce surety credit is available for other projects. On the other hand, they may find that the general contractor, sensitive to the amounts it is self-insuring, has imposed tighter controls on progress payments, requires personal guaranties, or asks for sensitive financial information that would not have to be provided in a bonded situation.

The Suppliers View of SDI

Suppliers to subcontractors may or may not find it as easy to extend credit to subcontractors on SDI projects. SDI affords them no direct payment bond coverage. They are required to file liens against the project and project owner, or claims against the general contractor's surety. Most subcontract payment bonds provide direct actions for suppliers and have less restrictive notice requirements than lien laws and statutory bonds. A supplier often has a claim against a subcontract bond when it has already missed the deadlines to file against the project or general contractor's bond. On the other hand, suppliers may take comfort that the general contractors will be more rigorous in their monitoring of payments and securing of interim lien releases, or more inclined to pay lien or bond claims with SDI as a source of recovery.

The Project Owners View of SDI

Project owners may find no significant difference between a general contractor bonding its subs and using SDI. The cost to the project is about the same.[12] A general contractor that bonds its subs may suggest that it has better prequalified subcontractors, higher coverage limits, and greater payment protection for suppliers and second tier subcontractors (which theoretically creates an opportunity for better pricing). The SDI user may suggest that it has greater ability to address a default in a timely manner because it does not have to wait on the surety to respond and investigate. SDI users often suggest that the absence of subcontract bonding requirements will mean that the SDI user has greater flexibility to employ the small and minority contractors who are so often the target of public owners' social goals. In truth, both are excellent risk management tools in the hands of the sophisticated and usually well financed general contractors who use SDI. Whether or not a general contractor bonds or uses SDI may make no greater difference to the owner than the type of scheduling software a general contractor may use.

SDI Overview

SDI is an alternative to subcontract bonds that some general contractors may find attractive. General contractors who prefer to step in immediately when a subcontractor defaults and take control of remedial action, as opposed to waiting for a surety to take action, may find SDI attractive. The possibility of reduced bonding costs, or favorable subcontractor experience translating into savings in its loss sensitive premium structure, is also a factor that may cause a general contractor to prefer SDI. However, the potential savings of SDI could be lost if the general contractor does not make the commitment required under the SDI insurance program to screening and hiring only reputable and financially viable subcontractors and in rigorously employing sound risk avoidance and minimizations practices such as those mentioned at the beginning of this paper. If the operational discipline required for SDI is strictly adhered to, many general contractors have improved their operations, and profitability, by being forced to evaluate the cost of "self" assumed/non bonded risks.

Those general contractors in SDI programs are only now realizing how much work the prequalification process is, and how many defaults the surety product may have prevented for them over the years.[13] Under the SDI program, the general

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[12] Subcontract bonds, whether quoted separately or as a part of subcontract cost, are a cost of the work, reimbursable under virtually all industry standard construction manager or cost-reimbursable contracts. While SDI costs would not be any less reimbursable from a "cost of the work" viewpoint, most industry standard agreements need some tweaking to deal with SDI issues.

[13] There is no question that the surety industry, as a whole, needs to continue to work on its image for responsiveness and responsible claims handling. Complaints about surety claims handling practices…sometimes justified and sometimes not…are one of the reasons, besides profit potential, that general contractors find SDI appealing. Over time, many general contractors have come to appreciate some of the unseen services of the surety industry…for example, the subcontractor that is financed and "propped up" by its surety behind the scenes. Between the administrative cost of prequalification and administration, and the begrudging appreciation for the

contractor participates with the insurer financially in losses. Indeed, the general contractor is self insuring a great deal of the exposure. The extent to which general contractors can effectively avoid and manage subcontractor defaults will determine the potential costs savings.

There are also general contractors who are very successfully conducting their businesses using neither bonds nor SDI, or using both infrequently. The risks may all be within their

Subcontractor Financial Prequalification

One of the most valuable services of the surety bond is the surety's independent prequalification of subcontractors. Prequalification is a process in which the surety underwriter and producer analyze the subcontractor's:

- Financial strength and credit history;
- Experience and reputation;
- Exposure and progress on other contracts; and
- Ability to perform the work; as well as
- Subcontract documents; and
- Size and location of the work.

A surety typically will have greater access to this information than a general contractor. The surety may be prequalifying the subcontractor for surety credit for many projects. The surety may have a long history of bonding the subcontractor. The subcontractor will share sensitive information with its surety on a confidential basis that it would never wish to share with its customer, the general contractor. As some general contractors have undertaken prequalification as a good general practice, or as required by their SDI program, they have realized that obtaining the financial information necessary to make good decisions is not as easy as they thought it might be….that it is hard to replicate the financial analysis that the sureties have traditionally done. They have found that prequalifying subcontractors is difficult without the detailed confidential financial data, work-in-progress, and personnel resumes, and business plans that the surety company and bond producer have at their disposal. In an effort to obtain better financial information on their subcontractors, many are requesting detailed information through questionnaires.

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difficulty of a surety's role in a subcontractor failure, it is the author's experience that many SDI users have gained a newfound respect for the surety product.

Some general contractors have staffed up to meet the challenge with their own prequalification departments. The SDI underwriters are taking a harder look at renewal time to make sure that SDI users have a formalized prequalification process and are using it. Some general contractors have created elaborate databases with financial, safety, credit, and performance histories of their subcontractors. They have hired accountants, surety underwriters, or risk managers to analyze that information and make recommendations on which subcontractors may be safely enrolled in their SDI programs. Some have turned to accounting firms, surety brokers, consultants, and other companies who offer this service for a fee. Third party services offer a certain objectivity, independence from internal management pressures, and often resources and experience that a general contractor would not be able to replicate internally. Third party services also offer subcontractors an opportunity to deliver proprietary or sensitive financial information, in confidence, to a third party without disclosure of the contents to the general contractor. Understandably, most subcontractors are not excited about revealing to their general contractor customers their profitability on that general contractor's, or even a competitor's project.

As contractors and subcontractors alike have moved assets from operating companies to holding companies, it has become more difficult to determine whether the subcontracting entity has any substantial worth or is viable as a standalone entity. While Subcontractor X may be a fine ol' company with whom the general contractor has done business for many years, general contractors are finding that Subcontractor X moved all its real worth upstairs to Subcontractor X, LLC. If often takes more financial information than a subcontractor would be willing to furnish a general contractor, and often more financial analysis expertise than the contract has in-house to unravel that information.

General contractors using SDI are taking on more risk and want the additional information to manage that risk. Whether or not subcontractors provide that information is, of course, up to them. Those who choose not to do so, however, are going to find their opportunities limited if more and more contractors begin to use SDI and take a greater interest in the financial strength of their subcontractors.

Funds Disbursement/ Funds Control Programs

Funds disbursement services, often called "funds control," "funds administration," or "construction escrow services" are services whereby a subcontractor's accounts payable functions are outsourced on a per-project basis to a third party escrow or disbursement service. In essence, the funds otherwise earned by a subcontractor are paid not to the subcontractor, but to a service provider who verifies costs, collects lien releases, and makes direct disbursements to the subcontractor's suppliers and sub-subcontractors on a pre-agreed basis. The level of control involved may be as light as what a general contractor might employ in routine joint checking of major suppliers to positive verification of costs and disbursement only of costs and allocable profit and overhead until the project has been completed.

Such services have proven to be a credit enhancement tool, an evaluation tool for contractors with limited experience, and an underwriting tool that allows sureties to extend or expand surety credit in certain circumstances. Funds disbursement services may be used in any situation where it is important that funds remain dedicated to the project on which they are earned. One such example would be a general contractor using a marginally qualified, unbonded, trade subcontractor, whether or not covered by SDI.

Funds disbursement services are not regulated in most states. Some states, like California, include such services under their Escrow Licensing Laws. In most, there is no regulation and no financial oversight. One case points out the dangers of dealing with any funds disbursement company that has not been thoroughly investigated. In *New York Marine and General Ins. Co. v. Beck Elec. Co., Inc.*, Slip Copy, 2007 WL 160689 W.D.N.C.,2007, January 16, 2007 Beck Electric Co., Inc. ("Beck Electric") contracted with Southside Constructors, Inc. ("Southside") to provide electrical subcontracting services for the Gaston County Administration Building construction project. However, due to its financial condition, Beck Electric was required by its surety to have a third-party funds administrator oversee the disbursement of funds from Southside to Beck Electric and/or Beck Electric's subcontractors. Beck Electric retained Houston, Texas based, Funds Administration Services, Inc. ("FAS") to serve as its third-party funds administrator. FAS allegedly misappropriated the funds entrusted to it and later filed bankruptcy. Beck Electric, deprived of the misappropriated funds, defaulted, causing a loss to its surety. The surety sued under its indemnity agreement to recover the loss. Beck Electric defended on the basis that FAS was an agent of the surety, and that the surety should therefore allow the misappropriated amount as a credit against Beck Electric's indemnity obligations. The Court found for the surety, leaving Beck Electric to suffer the losses caused by FAS's defalcation. The lesson: prequalify the funds administration service provider too!

Funds disbursement services are priced on dollar volume, length of project, and the complexity of the controls in place. An average of 1% of the contract amount on smaller projects is common, although the fees typically break as the subcontract price increases.

While joint check processes may send a message to the suppliers that a general contractor lacks confidence in the subcontractor, many funds disbursement processes are performed in a manner that third parties are unaware that it is being used. The checks from the disbursing company or escrow service may be imprinted with only the subcontractor's name and address.

Most subcontractors would prefer not to have their funds controlled and disbursed in this fashion. They fear that there will be disagreements over who should be paid, whether the process will slow down payment, and a certain amount of duplication of accounting functions. To the subcontractor who would otherwise not

qualify for bonds or to work for an SDI user, however, it is a process that creates opportunities where none may have existed before.

With increasing frequency, owners and lenders are requiring funds to be disbursed through escrow, either to obtain favorable pricing from subcontractors and other project team members, or to guard against default. Even those who require bonds sometimes prefer the comfort of knowing that project funds will positively remain dedicated to the project and not be used elsewhere.

A Word about Cost Reimbursement for all of these Products and Services

Public owners increasingly have the ability to do "best value" procurements where contractors, construction managers, and design-builders are hired on merit, not low price. These new delivery methods are often done on a cost plus a percentage fee basis. From time to time, a public owner will naively ask, "If we got a bond from the general contractor, why should be have to pay for the general to bond its subs?" Why such questions arise, I do not know. Subcontract bonds costs and SDI premium costs are, of course, compensable. Subcontract bonds or SDI premiums[14] are as much a cost of the work as the subcontractor's CGL coverage or workers compensation premiums. All major trade association promulgated standard construction forms consider such costs as compensable.[15]

There are some inquiries about subcontract bond or SDI costs that would be entirely appropriate at the proposal stage.[16] Some owners want to know if a general contractor bonds some or all of its subcontractors or uses SDI. Those are, of course, good questions, the answers to which demonstrate the general contractor's risk management philosophies and may have some indication of the quality of subcontractor that will be on the project. To suggest that a general contractor that does not bond its subcontractors or use SDI is somehow more competitive is a false

[14] A project owner may question whether or not only the minimum risk transfer portion of the premium should be reimbursable. Indeed, some general contractors only charge that portion plus their administrative costs as a reimbursable cost to the owner. But, those contracts are also structured to make the general contractor's deductibles and co-pay a fully reimbursable cost of the work…and the contract would have to stay open until the warranty and statute of repose has run to calculate it… typically a much larger and longer exposure than any project owner would wish to deal with.

[15] AIA A121/CM (1991), for example, is one of the most common contract templates used by public owners in their Construction Manager at Risk Procurement. It includes as a cost to be reimbursed, in Section 6.1.6.1, "That portion directly attributable to this Contract of premiums for insurance and bonds." It goes on to state that the CM should further specify the basis for reimbursement "if charges for self performance are to be included."

[16] Owners would be well advised to inquire how general contractors plan to deal with subcontractor risks and price their risk transfer costs in their requests for proposals. To say in the RFP, however, that a general contractor will not be able to include subcontract bonds or SDI in its costs, if the contract is awarded, could have an adverse impact on competition. It would be like saying, "General contractors who pay truck allowances to their superintendents instead of higher salaries need not apply." General contractors each have their own means and methods of performing work, and their own methods of dealing with risk. To single out, or restrict, one element of their practices is shortsighted and reduces competition. Contractors should also be careful that the loss sensitive structure of their SDI program are not viewed incorrectly as creating rebates or hidden returns that might run afoul of any of the provisions of a cost-plus contract or violation of anti-rebating or similar laws relating to public procurement.

premise. The minor savings to the project in terms of bond or SDI premiums, compared to the overall project cost, may pale in comparison to costs, delays, or quality issues associated with a subcontractor failure. The savings in premium may actually show up in other reserves or costs incurred by the general contractor in dealing with subcontractor risk issues.

Choosing any general contractor in a best value procurement because its fee or fee and subcontract risk costs is lower than another general contractor's, when the overall project price is not known is like choosing and buying a car based solely on the cost of the tires.

Conclusion

Good subcontract risk management starts at home, with people and procedures focused on minimizing the risk of subcontractor default. No insurance or surety product…no third party service…will work unless the general contractor accepts this premise.

Having accepted this premise, there are a number of products and services available in the marketplace to reduce the risks of subcontractor failure. Each of these products and services are tools. No one tool is best. Each has its purpose. More than one tool may be needed on any project. It is hoped that the foregoing will be beneficial in the selection and use of those tools.

About the Author

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