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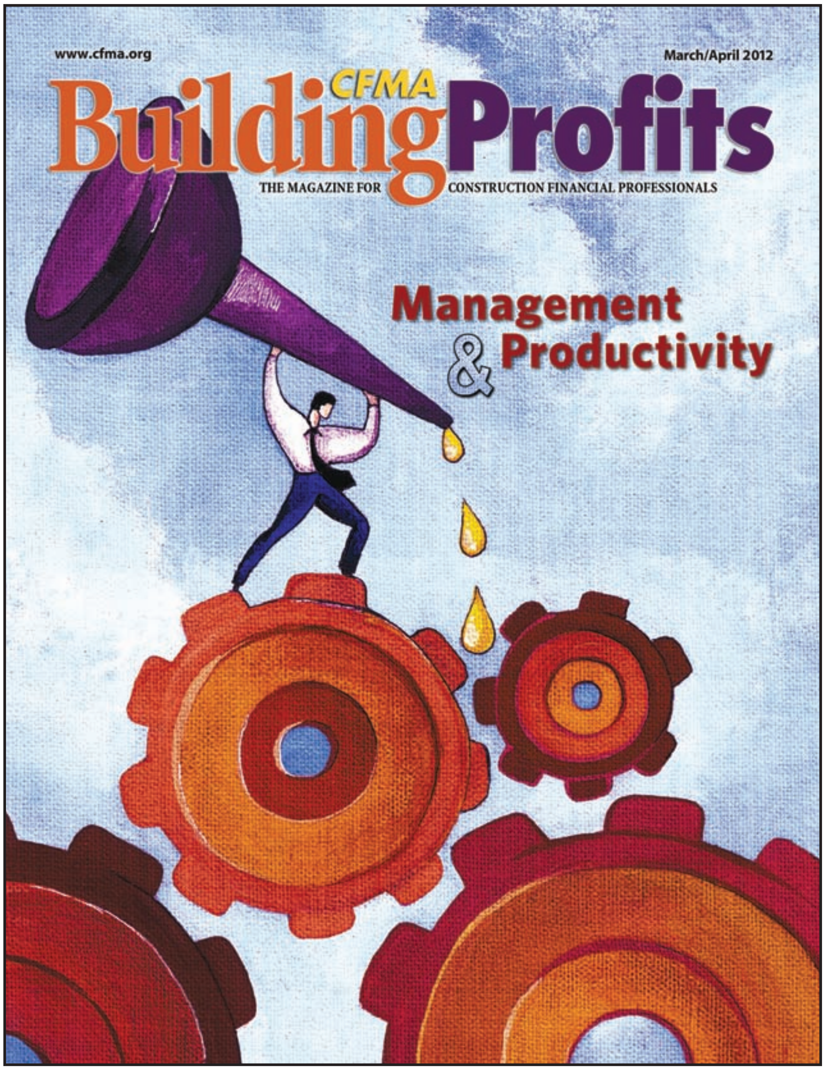

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The Source & Resource for Construction Financial Professionals

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The Nuts & Bolts of Subcontractor Default Insurance

Since its debut on the market more than 15 years ago, subcontractor default insurance (SDI) has been used to protect against subcontractor and supplier default.

Designed to replace performance and payment bonds and address the shortcomings of the claims process with a two-party insurance policy, SDI enables insureds to better control claims and project schedules by defaulting a subcontractor quickly and efficiently and protecting against incurred costs.

With the recent increase in subcontractor defaults and insolvency, the demand for SDI is expected to continue. Let's take a look at the elements of SDI, review the costs involved, and weigh the pros and cons.

Program Structure

SDI is a non-admitted (not regulated by state insurance commissioners and generally not guaranteed by states against insurer insolvency) indemnification policy wherein the insured must demonstrate that it has paid amounts to complete a contract beyond the remaining subcontract balances (including approved change orders) as of the date of default, known as "proof of loss." The policy calls for reimbursement of such costs within 30 days. The policy in force when the subcontract was enrolled will respond to the claim.

An SDI claim includes direct losses, the actual cost of completing the contract, plus such indirect costs as internal overhead, liquidated damages, and other consequential damages.

Indirect Costs

To simplify documentation of indirect costs, carriers offer assistance with project schedule evaluation and impact caused by the defaulting subcontractor, implementing Critical Path Method (CPM) techniques to track the consequences, CPM training, and additional documentation and alerts to gaps or deficiencies in the claim.

Indirect cost coverage can also be set as a percentage (10%, 20%, or 30%) of the direct costs, but will impact the premium. When a claim is filed, the carrier will reimburse the direct costs plus the selected percentage for indirect costs.

This option is designed to eliminate the complicated documentation required to prove an indirect loss and the resultant friction between the insurer and the insured. While this option may work well for some claims, it could limit the coverage for complex claims with significant indirect costs.

Who Is Covered?

All subcontractors and suppliers on a project are covered under SDI unless they are bonded. This gives the insured flexibility in managing its program, allowing it to bond subcontractors or suppliers that are viewed as risky; this includes subcontractors that have a longer tail exposure (claims that may take years to manifest) or create a greater risk of water intrusion (e.g., roofers, curtain wall or cladding subcontractors, waterproofers, or window installers).

To enforce such an arrangement, the insured can continue to require bonds from these trades.

Coverage Limits

Coverage limits are determined by:

1) The largest payment that can be made on individual subcontractor default, which may occur over more than one contract or project, and

2) The maximum total payment available over an entire program (aggregate limit), which is typically larger than the single claim limit.

The coverage limits, deductibles, and co-pays vary depending on the risk profile of the insured.

SDI policies provide significantly longer tail coverage than surety bonds. Typical SDI programs have tail coverage of five or 10 years, while most surety bonds have a two-year suit limitation. Sureties will, however, provide warranty guarantees of 1-3 years for large subcontractors.

Policy Exclusions

There are a number of exclusions contained in an SDI policy, such as misrepresentation, fraud, defaults occurring prior to the policy term, subcontracts acquired from other entities, losses arising from the insured providing professional services, or losses resulting directly or indirectly in bodily injury.

Some of these are undesirable or uninsurable, while others are covered elsewhere in a contractor's insurance program. Some carriers may also deny a contractor coverage if it fails to follow the prequalification procedures presented at the time the policy was issued.

In the event that the defaulted subcontractor has any recoverable assets, the carrier retains the right of subrogation against the defaulting party. While not the norm, there are circumstances that will allow assets to be recovered. Any recovered assets will go to the insurer first to fund its loss and then to the insured.

Underwriting Process

The contractor is responsible for subcontractor prequalification and completion of any defaulted contracts. Thorough prequalification is essential to a successful program, and the carrier will underwrite this closely.

(For more information on this topic, see "Prequalification Management: Reduce Risk & Get Work" by Herbert W. Brownett in the July/August 2010 issue and "Prequalification from the Subcontractor's Point of View" by David A. Walls in the November/December 2011 issue.)

Sound project management and quality control protocols are also critical to the success of any SDI program, and are thoroughly reviewed by insurers as part of the underwriting process. This includes quality subcontract documents, effective project accounting and funds control, and detailed project management reports.

Plan for Implementation

An effective management plan for SDI implementation is an important step to maximize the value of this risk management tool.

While most contractors already have some procedures in place to manage this process, almost all contractors new to SDI find the need to improve procedures and controls in this area. This can create a significant investment in staff and systems.

Although insurers offer risk engineering assistance in formulating a prequalification process, they have not yet provided a software tool or resource to assist with this. However, third-party vendors and brokers are beginning to address this need.

Program Costs

Premiums

SDI can be designed as a retrospectively rated policy under which all premiums paid into the program may be tax-deductible. Standard premiums for SDI policies have two components:

1) The risk transfer premium, which is the amount that goes to the carrier to cover the risk transfer cost for losses above the deductible; and

2) The loss fund/retrospective premium, which represents funds that are paid to the insurer to pre-fund losses under the deductible layer, similar to the subject premium in a retrospectively rated workers' comp policy. The carrier does not retain these funds if no defaults occur during the policy term.

Final premiums are based on an insured's actual loss experience during the policy term. In an SDI policy without losses, the loss fund/retrospective premium is fully refundable to the insured. In practice, these funds may be left with the insurer to build up a larger loss fund and potentially take a higher deductible as the program matures.

In comparison to surety bonds, which might run $10-20 per $1,000 of subcontract value (1-2%), SDI premiums are generally $3-6 per $1,000 of covered subcontracts. The difference is available for a GC to pre-fund any deductibles that may arise in the event of a default; but, in the absence of losses, the funds are a source of profits.

Deductibles

SDI is a large deductible insurance product, with pricing driven primarily by the terms and conditions desired (limits, deductibles, etc.) and a company's risk profile (size of subcontracts, type of work, etc.).

Typical deductibles range from $250,000-1,000,000. Contractors can purchase an aggregate deductible to cap their cost of deductibles in the event of multiple claims, which varies from two times the individual deductible to higher multiples. The choice of aggregate deductible amount is a significant cost driver.

Co-Pays

In addition to the deductible, a contractor is required to pay a percentage of each loss (usually 10-20%) for values in excess of the deductible (the co-pay). After the co-pay reaches a predetermined value on a claim, the insurer then pays 100% of the remainder of the claim. Selecting a higher co-pay percentage will reduce a contractor's premium.

One carrier has added a feature that will waive the co-pay percentage if the loss is reported promptly (within five business days from the time written notification is sent to a subcontractor that it is in default of performance).

As more carriers have entered the SDI market, programs have begun to be designed around enrollment volume rather than an arbitrary annual term. Policies are designed to be "filled up" over a specific term (generally 12-18 months) and can be extended if necessary, rather than be subject to a minimum premium, which is advantageous to insureds.

Pros & Cons

SDI offers both advantages and disadvantages over bonding. From the insured contractor's perspective, there is greater control over the claims process, a greater degree of consistency (due to common coverage terms and conditions), and potentially significant cost savings (if losses are contained).

Unlike bonds, where the coverage is generally limited to the penal sum or contract value, SDI offers coverage to the policy limit, which typically is significantly greater. Contractors also have the opportunity to exercise a greater degree of control over who is enrolled and how to manage a job in the event of default.

The tradeoff is the need to staff and manage a rigorous prequalification process. We find that the most sophisticated contractors that rely on bonding for protection are doing this anyway. As such, a move to SDI typically entails fine-tuning the prequalification process – not starting it from scratch.

From a subcontractor's perspective, participating in an SDI program alleviates the need to utilize capacity in its own bonding program. The flexibility allows the SDI insured to reach out to minority, small, or otherwise disadvantaged subcontractors and can help the contractor and owner advance other objectives, which might benefit public policy. While some subcontractors may find the rigorous prequalification process objectionable, others may find opportunities in selling their financial strengths and operational excellence.

Another perceived downside is the lack of payment protection for second-tier subcontractors or suppliers. However, this risk is covered by SDI. If a subcontractor hasn't paid its second-tier subcontractors or suppliers, and that results in a lien on the project, then the subcontractor is in default of its contract.

The cost of paying these parties is considered a direct cost under the policy. Second-tier subcontractors and suppliers also bear the risk of nonpayment when bonds are not in place (which often occurs on smaller projects).

Unfortunately, second-tier subcontractors and suppliers don't have the necessary leverage to control this risk. Moreover, it could be better addressed through the bonding protection provided to the owner through the GC.

Of course, a subcontractor that is not being paid on any project, whether bonded or covered by SDI, has the right to place a lien on an owner's property (subject to time limitations and local lien laws).

With more unilateral coverage through SDI, lower-tier subcontractors may get paid more expeditiously if the prime contractor is the source of non-payment (and not the owner). Although SDI does not necessarily preclude bonding the GC, it can when used in the private market.

Final Thoughts

Testifying to the increased demand for SDI, there are now three carriers that offer this product (after more than a decade of only one carrier offering it).

The success of an SDI program depends on management's commitment to the concept, diligent prequalification efforts, and appropriate feedback tools to monitor risk aggregation, bidding data, and subcontractor quality ratings.

Remember, SDI is not meant for all contractors or all projects; only those contractors that are comfortable with taking over many of the duties traditionally managed by sureties (e.g., prequalification and claims management) and the inherent balance sheet risks associated with a large deductible insurance program should pursue an SDI program. ■

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