Managing and Mitigating Subcontractor Default Risks

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Over the last several years, the construction industry has presented certain challenges that place general contractors and subcontractors at higher risk of default. For the most part, subcontractor defaults occur during an upswing in the market, not in a downturn. The construction companies that survive downturns often come out as leaner versions of themselves. As the availability of work rises, the ability to perform that work diminishes and the default rates begin to increase. Although there are certain steps that should be followed once a subcontractor default occurs, this article focuses on the available options to manage and mitigate the risk of subcontractor default prior to default occurring. Part I of this paper focuses on the emergence of Subcontractor Default Insurance (“SDI”) in the last few decades, and the benefits derived therefrom. Part II then examines the alternative of requiring subcontractors to post performance and payment bonds. Part III then identifies other methods beyond SDI and surety bonds for mitigating subcontractor default risk.
I. **SUBCONTRACTOR DEFAULT INSURANCE**

   **A. History of Subcontractor Default Insurance**

   The history of SDI dates back to the 1970’s and 1980’s when the construction and surety industry saw the use of subcontractor bonds increase dramatically, which eventually led to more claims. The handling of subcontractor claims proved to be more difficult and challenging than claims against bonds posted by general contractors. Subcontractors retained the rights of any obligor to stand their ground against domination by the sureties. The routine requirement for personal indemnities from subcontractor’s ownership led to contentious disputes over the default and cure clauses in the underlying bonded subcontracts. General contractors, as obligees on the bonds, faced pressure to avoid costs and time delays, which intensified as the sureties struggled to control the work and move promptly to finish the subcontractor’s work. General contractors started to grow increasingly frustrated. The cost and time to push the sureties to perform led to deeper analysis of the total cost of subcontractor bonding. Premiums and the cost of litigation combined with the delay and cost of replacing subcontractors all drove the search for a better alternative response to subcontractor defaults. The surety option was increasingly seen by major contractors as too expensive and too slow to be considered effective to mitigate losses arising from subcontractor defaults.

   Subguard© was developed as a two-party agreement to reduce the cost and time to cure a subcontractor default, and the first carrier to support this type of policy was Zurich. Using a classic trade credit insurance policy as a starting point, Subguard© was developed to respond once the general contractor declared a default. The insurer establishes in the policy the process for triggering coverage and details the steps to begin recovery of the consequent loss. An important prequalification step for the Subguard© underwriter is the analysis of the general contractor’s own prequalification process for selecting and awarding work to its subcontractors. The insurer also operates as an excess of loss cover with meaningful co-insurance participation by the general contractor.
Early adopters found success in reduced frequency and severity of subcontractor defaults. The initial buyers establish more formal and robust subcontractor prequalification standards to include financial strength of each subcontractor. Insurers do not accept marginal subcontractors for inclusion under the policy. As a result, general contractors have adopted more rigorous alternative methods for using less qualified subcontractors, such as joint checking or paying for materials on a direct basis.

The SDI claims process is a less litigious solution. While forensic accounting and engineering continues to be required, the claims response takes place outside the scope of lawsuits. The insured and insurer typically investigate costs and cures without needing to seek legal recourse.

While traditional surety continues a long run of success, the early concerns that SDI would diminish surety premiums never materialized. The buyers of SDI continue to be somewhat larger, financially stronger and more risk aware. The SDI product has expanded to certain international markets and is also available to some owners. It continues as a viable alternative to the traditional three-party surety product.

**B. What is Subcontractor Default Insurance? How is it different than a Surety Bond?**

SDI is simply an insurance policy that provides insurance protection for a General Contractor in the event a subcontractor defaults on their contractual obligations under a subcontract agreement. The event that triggers a default under SDI is the same as that which triggers a loss under a surety bond. The Sub must be in default on the sub contract for a loss to occur. There are, however, a number of differences in each product and for many firms; both products have a very viable and acceptable place in their management of risk.
C. How does SDI work in comparison to Surety Bonds?

Since most general contractors are familiar with the traditional approach of accepting a surety bond from a subcontractor, a comparative discussion should help with understanding SDI and how it might be used by a general contractor. Below are some factors to consider:

1. Enrollment

After a client goes through the underwriting process and chooses to start a SDI program, they have the option of enrolling projects and or subcontractors using several different approaches. For instance, the client can choose to enroll subcontractors by project. Thus, any subcontractor or purchase order executed on that contract is enrolled for coverage in that policy period. Many firms choose to exclude purchase orders. The insured limits purchased, deductibles selected and/or aggregate limitations all apply only to the group of subcontractors enrolled for those specific projects. In this case, enrollment of subcontractors may occur over a multiyear basis but they attach to the policy year based on the projects enrolled during that policy period.

Alternatively, the clients can choose to enroll all subcontractors and purchase orders during a policy year with the exception of those subcontractors that they choose to bond. Insured limits, deductibles and aggregate limits apply to all subcontracts signed during that policy period. There are also programs where the general contractor can enroll subcontractors on a purely reported basis during the policy period. This is similar to the programs where the subcontractors attach during the policy year based on the execution date of the subcontract, except a general contractor must report the subcontractor in order for coverage in the program to apply, rather than the sub being automatically enrolled. In all cases, the client can choose to have enrollment
only apply to those subcontractors over a pre-defined dollar amount, or they can choose to have all subcontractors included.

If surety bonds are used to guaranty subcontractor performance, the general contractor accepts performance and payment bonds that, in most cases, provides bond coverage in the amount of the subcontract. The specific bond coverage will apply only to this specific subcontractor based on the terms of that specific bond. There could be quite a variation in the terms of each bond based on what the specific surety provides. The financial strength and approach to claims of the surety companies supporting each bond may vary quite a bit between companies. Even if a general contractor used its own specific form, there seem to always be exceptions that arise.

2. **Limits of Coverage**

There are some significant implications in regards to limits of coverage. Under SDI, the client seeks to determine the amount of potential exposure they face for a single loss and an overall aggregate exposure for multiple losses, and then purchases an appropriate limit of insurance from the SDI carrier to cover this exposure. This is similar to how all insurance purchasers buy insurance for all the traditional exposures that they insure. Under a surety bond, because the amount on the bond is tied to the amount of the subcontract, the general contractor may only recover defaults up to this amount. There are clearly cases where this amount may not be enough to cover the full default cost with the subcontractor.

Another significant factor to consider is the aggregate liability limit for all losses. If a general contractor requires performance bonds, they will have a limit for each individual bonded subcontractor. In most cases, there are some subcontractors that are not bonded so any cost associated with a default on those subcontractors is born by the general contractor. When you
add up the total bond limit on all subcontractors for all jobs it is likely that the limit will be higher than an aggregate limit purchased under SDI. Clearly this is something to consider but this is an issue that can be managed as your structure your SDI program.

3. **Approach to Claims**

One of the most critical differences between SDI and surety bonding relates to how claims are handled. For years, project participants have been frustrated with the processing of performance bond claims. There is an inherent risk created by the nature of the fact that surety is a three-party contract as follows:

![Surety Bond Diagram]

With bonding, the surety guarantees the subcontractors performance under the subcontract agreement. In the event of a default they stand behind the subcontractor’s obligations. A critical element to a surety agreeing to provide surety bonding for a subcontractor is that the subcontractor and, in most cases, the subcontractor’s ownership personally indemnifies the surety for providing the surety bond. Thus, the surety will be looking to these individuals before they step up solve a default. In many cases this element will cause a surety to hold off responding to a claim as they do not want to step into a problem and cause a situation where they have the potential to void indemnity that they might use to recoup any loss that they incur. The
surety’s primary focus is to remedy the claim by adhering to the subcontract terms, and the overall project’s progress is not a primary factor in their decision-making process. Since the surety typically controls the options for the approach to completion of the subcontract, the impact on the overall project may not be factored into the ultimate decision on how best to complete the project. The other default situation commonly faced by general contractors is the bankrupt subcontractor. When the surety investigates, general contractors often see the surety exercise defenses related to the cause of the default which would discharge the sureties’ obligations under the bonds, which not have been raised but for the fact that a large, deep-pocket entity is now able to fund the defense under the subcontract. What happens in many surety claims is that the general contractor is forced to fund the default issues in order to keep the project on schedule, and then work to collect the cost after the project is complete. Of course, this does not happen in all surety claims but, given the number of sureties in the market and the different approaches to handling a default, most firms who have had to deal with a subcontractor surety claim have experienced this situation.

Under SDI there is a completely different approach to how defaults are handled. When the general contractor declares the subcontractor to be in default and follows the appropriate notices required under the subcontract agreement, they can then pursue their SDI claim. The general contractor is obligated to provide the insurer notice of the default, and at that point they fully control how best to remedy the default. They have full control over whether they decide to hire a replacement contractor, supplement the work with another contractor, or any other option they deem best. The fact that a general contractors’ primary concern is typically maintaining the project schedule which is a significant advantage. Once they incur cost in excess of the contract price they can then submit claims cost to the carrier for re-imbursement. The carrier will pay
95% of the claim at that point. Thus, the general contractor avoids a situation where they are out significant funds during the course of the project, and have to pursue collection from the surety afterwards. Flexibility in how a claim is settled is a key advantage of SDI over surety bonding.

4. **Subcontractor Pre-Qualification**

One of the purposes of the surety bond is to prequalify subcontractors in order to approve their overall ability to complete a project. The surety will require a firm to go through a rigorous underwriting process, which typically includes a review of the financial resources of a firm, their previous track record on projects, reference checks as to the character of the company owners and a review of their other credit facilities. Only after a subcontractor has undergone an appropriate review will the surety agree to provide bonding. Demonstrating the ability to provide bonding should make a firm more qualified to perform work.

Under SDI, the general contractor assumes the primary responsibility for pre-qualifying subcontractors. We find that most strong firms have some prequalification process they perform on their own even if they chose to use bonding. It makes good business sense to do so. Generally, they are closer to the action than a surety underwriter and are able to find out earlier if a subcontractor has a problem that needs to be considered even if the subcontractor can provide a bond. However, when a general contractor decides to use SDI, it usually makes sense that they enhance this process to some extent.

5. **Post-Subcontract Mitigation**

With surety bonds, one the bond is issued, the surety has very little control over what happens on the bonded project. They can, of course, stop providing bonds on new projects but they generally have little input after that. The exact opposite is true for a general contractor. They have the ability to truly influence and impact the magnitude of any default that occurs as
they manage the subcontractor on the project. By getting proper lien releases, moving to joint checks when they observe payment issues, holding payment for work not performed appropriately and making sure that they do not allow the subcontractor to bill for more work than performed a general contractor can truly impact the size of a loss should a default occur. In fact, many of these post-subcontract factors are as important - if not more important - than the prequalification information as a subcontractor’s financial situation can change dramatically in the course of a project. Thus, good overall project management and processes is very important in subcontractor management whether you use SDI or surety bonding.

6. **Financial Rewards**

With surety bonding, a general contractor funds the cost of the bonds in his project cost and he receives the benefit of the protection. If his processes are very good, the likelihood of default and the ultimate loss associated with a default will be lower on his job than the surety faces for other risks. The surety, not the general contractor, receives the benefit of his strong management processes that reduce losses. A well-structured SDI program is structured so that the general contractor has the ability to receive a financial benefit from selection and management of subcontractors while at the same time mitigating downside risk over and above the cost that would have been paid for bonding.

7. **Subcontractor Selection**

Under SDI, the insurance carrier will underwrite the prequalification process of the general contractor as well as their management process. Once the carrier is comfortable with the general contractor, it allows the general contractor to make all the decisions on which subcontractors they chose to allow in the program. The only exception is subcontractors whose contract value is in excess of $40 million dollars. When you consider that the general contractor
has a significant financial interest in not having losses and, therefore, the interest of the insurance carrier and the general contractor are aligned, the carrier will allow the general contractor full control of selection of subcontractors and management of claims.

8. **Coverage**

Coverage under surety bonds and SDI, while triggered by the same event, is slightly different. Under SDI and surety bonding there is coverage for direct cost associated with defaults. These costs include things you would normally see under the performance bond like the cost of replacement contractors in excess of the original contract amount or the cost of supplemental contractors over the original amount. In addition, both provide recovery for the cost of unpaid material suppliers you would see under a payment bond claim. One major difference is that under a surety payment bond, these material suppliers can file claims directly to the surety under the bond. With SDI, claims are filed by the general contractor to the insurance carrier for payment bond type claims. Since these claims are filed by the general contractor, they can chose not to file claims that are invalid because of a failure to follow appropriate notice requirements or failing to file a proper lien. Even if a claim is not valid the general contractor has the ability to have these claims covered.

Another critical element of coverage for SDI programs is the duration of the time for making a claim. While the time duration for making a claim against a performance bond may vary from state to state, most would agree that the intention is for coverage to apply during the construction and warranty phase as well as any period of statute of limitations for latent defects required by law under the contract terms. In some jurisdictions, this is not the case. For example, the time limit for making a claim against a performance bond in Florida is five (5) years even though the contractor is responsible for ten (10) years under their contract. Under SDI it is clear
that coverage applies for lesser of the term of ten (10) years or the statute of limitation under the subcontract. The carriers do have some exceptions for this when they are providing coverage for residential construction so it is important to look at the terms of the program on this point. SDI extends out similar in nature to a surety bond or longer in some cases, and with more and more cases related to construction defects this is becoming important.

**D. Subcontractor Default Insurance in the Tough Economic Market**

As the economy continues to recover, most experts predict that we will continue to see more subcontract defaults. You would expect this trend to continue as margins have been reduced across all lines of construction as competition for work continues to be fierce. What does this mean for surety and SDI? While most firms will not be expanding their surety capacity, it is clear that it is expected to be more difficult for subcontractors to qualify for surety credit. Thus, many general contractors who are bidding projects will be forced to consider subcontractors who either have indicated that they could provide a surety bond when they priced the job but now cannot, or they have subcontractors who cannot obtain bonding who they may be forced to use based on their price in order to be competitive. In the past, the only option was for the general contractor to assume this risk without any risk transfer protection of a surety bond in those cases if the company wanted to use those prices. SDI provides a great option for protection during very difficult markets. While the risk of default may be higher during this time, under a well-structured SDI program, the downside risk to the general contractor is limited to the profit potential that the firm might have earned under SDI had they not suffered any losses. The flexibility to choose those subcontractors while having protection from financial loss because of a default is a powerful tool that can be used to get projects in this economy. To be successful with this approach, it is critical that you have the strong management procedures in place so as to
provide proper management of subcontractors who have a higher risk of default and who can avoid a large loss if they do default.

SDI is a product that provides the opportunity for general contractors who manage risk well to benefit with more control when losses do occur, more selection in who they work with so as to be more competitive as well as the opportunity to deliver a profit with very minimal risk.¹

II. SUBCONTRACTOR PERFORMANCE AND PAYMENT BONDS

A. The History of Performance and Payment Bonds

Unlike SDI, performance and payment bonds have played a significant role in the United States construction industry, particularly public projects, for over 150 years.² Suretyship in the construction industry arose in the late 1800s in response to the need on public projects to protect against contract default as well as to ensure that subcontractors, laborers, and materialmen from nonpayment.³ In 1894, after a financial panic caused individual sureties to default on $35 million of unpaid debts to the U.S. Government, Congress enacted the Heard Act, which required that performance and payment bonds for federal projects be issued by “good and sufficient” sureties, and approved by the Department of the Treasury.⁴ Numerous states thereafter adopted “little-Heard acts.”

The Heard Act, however, was fraught with substantive and procedural limitations.⁵ Therefore, in 1935, Congress passed the Miller Act, which required separate performance and payment bonds for general contractors. Since 1935, all of the states, the District of Columbia, Puerto Rico, and several local jurisdictions have likewise enacted their own Little Miller Acts. Although some state Little Miller Acts authorize the acceptance of either bonds or other forms of security, corporate surety payment and performance bonds remain the construction contract
guaranty of choice. As a result, there are over a century of court decisions interpreting the Heard Act, Miller Act, and Little Miller Acts.\(^6\)

**B. Performance and Payment Bonds Generally**

At its core, any surety bond is a three-party agreement whereby the surety becomes liable for the principal’s debt or duty to the third-party obligee.\(^7\) In the construction industry, the two most prevalent surety bonds issued are performance and payment bonds.\(^8\) A performance bond provides assurances to the obligee that the principal-contractor will complete the project in accordance with the contract documents. Conversely, the payment bond secures payment to the principal-contractor’s subcontractors and suppliers. Although performance and payment bonds arose primarily in the context of public projects as discussed in Subsection A, above, over the years performance and payment bonds have become more of a mainstay in private projects as well.

**C. The Rise of Subcontractor Bonds**

Although the Heard Act, and later the Miller Act, required only that general contractors furnish performance and payment bonds, over the years it has become far more common to see subcontractors being required to post bonds as well. Notably, these subcontractor performance and payment bonds operate quite similar to a general contractor’s bond. For the performance bond, the surety guaranties the performance of its principal (the subcontractor) to the obligee (the general contractor). Furthermore, the payment bond guaranties payment to any claimants (sub-subcontractors and suppliers of the subcontractor). Similar to the general contractor’s bond, except in unique circumstances, the obligee can only make a claim against the performance bond, as the payment bond is limited to the protection of downstream subcontractors and suppliers.
There is, however, one key distinction between general contractor and subcontractor bonds on most public projects. Since the Miller Act, and most Little Miller Acts, only require general contractors to furnish performance and payment bonds on public projects, subcontractors on public projects are not required to furnish performance and payment bonds pursuant to the Miller Act. Therefore, the statutory requirements and deadlines of the respective act are not read into the subcontractor’s bond, which is in fact a private surety bond. Furthermore, although instructive to many court’s, the caselaw interpreting the Miller Act does not control subcontractor payment bonds. This has been a particular point of confusion for unfamiliar attorney’s and consternation for sureties where the Miller Act or Little Miller Act may provide a limitations period of less than a typical breach of contract action, while the statute of limitations for other surety bond suits is far longer.

D. Current State of the Market

Subcontractors are being called upon more regularly to furnish performance and payment bonds in on federal, state, and local projects. Private projects, particularly large multi-family and non-residential projects, likewise more commonly require subcontractor bonding. In fact, often on private privates, larger general contractors are requiring subcontractors to post bonds while at the same time themselves remaining unbonded. Because of this increase, there is more surety credit for subcontractors than ever before. The National Association of Surety Bond Producers (NASBP) has identified 112 corporate surety companies that provide bonds for subcontractors.

Furthermore, the U.S. Small Business Administration offers two programs to surety companies to provide them incentives to underwrite bonds for subcontractors. In the first, the “Prior Approval Program,” the surety submits all bond application to the SBA for review and approval. The SBA then guaranties 90% of the surety’s losses on small contracts up to $100,000, as well as for socially- and economically-disadvantaged, HUBZone, veteran-owned, and 8(a)
Business Development Program small businesses. The SBA will also guaranty 80% of certain bonds for individual contracts of much higher value in the contracting officer certifies that the guarantee is necessary for the small business to obtain bonding. In the second program, the “Preferred Program,” the sureties can issue, monitor, and service bonds for certain small businesses regularly without prior approval; however, the SBA only guarantees 70% recovery on these bonds.

E. Benefits of Surety Bonds over SDI

As a product that has existed since the beginning of recorded history, surety bonds have numerous benefits over SDI to minimize the risk associated with subcontractor default. Whether these benefits outweigh the burdens certainly depends on each individual case: the size and duration of the project, the general contractor’s own abilities, and the type of contractual vehicle just to name a few.

1. Thorough Subcontractor Prequalification

As discussed further in Section I(C)(4), above, perhaps the most often-cited benefit to bonding over SDI is the surety’s extensive prequalification of the subcontractor. Sureties write bonds with the expectation that it will suffer no loss in the event their principal defaults. Therefore, the surety will only bond those subcontractors that have the financial wherewithal to reimburse the surety by way of general agreements of indemnity, either through its own assets or the personal assets of its subcontractor’s officers or members, for any loss it may suffer on a particular project or series of projects. By ensuring that the subcontractor’s ownership has a vested interest in successfully completing each project, the subcontractors that receive a surety bond have little ability to merely shut their doors and move on in the event of a default.

Sureties are in a unique position to assess subcontractor capability, capacity, and character. While some level of subcontractor prequalification is routinely performed by the
contractor, the surety underwriter reviews the subcontractor’s financial statements, evaluates the subcontractor’s experience and assesses the subcontractor’s organization and equipment. The surety typically will obtain, at a minimum, the following information from the subcontractor:

- Quarterly financial statements
- Updated backlog data
- Bank letter regarding any line of credit
- Organizational information
- Business plans/bonding needs
- Information regarding the specific project to be bonded including a copy of the construction contract

Furthermore, the surety and its principal often have a long-standing relationship that extends beyond one project. Most principals generally do not want every general contractor to have access to their proprietary financial information, and have far fewer concerns with providing sensitive information to the surety. Therefore, the subcontractor’s surety often has access to far greater performance and financial data not available to the contractor.

The surety also has a seasoned staff with formal processes for underwriting subcontractors. Once the underwriting process is completed, these underwriters are able to translate all of the required information and their years of experience into a determination on whether to bond the subcontractor, and in what amount.

2. **Multiple performance options**

Once the subcontractor is declared to be in default, the surety has team of experienced professionals ready to step in and investigate the contractor’s claims. If the surety determines that the subcontractor is, in fact, in default, and depending on the specific provisions in the bond
form, the surety can then proceed forward with a menu of options. Unlike SDI, which will is limited to paying the contractor for the costs it incurs to remedy the default, the surety can also do the following depending on the circumstances:

- Finance the principal to complete performance.¹⁴
- Supplement the principal
- Enter into a takeover agreement
- Retain a replacement subcontractor and tender that subcontractor to the principal

Thus, where the source of the default may merely be cash flow or man-power problems, the surety can take action to prevent the need for the general contractor to even disrupt the project by terminating the defaulting subcontractor. This may result in substantial time and cost savings to all project participants.

3. **Payment Protection For Sub-Subcontractors and Suppliers**

As discussed further in Section I(C)(8), above, sub-subcontractors and suppliers cannot make claims under the SDI policy. Therefore, the owner and general contractor may still bear the risk with SDI that the subcontractor will not pay downstream project participants. However, the subcontractor’s payment bond should provide lower tier claimants with 100% security and protect the owner and general contractor from the risk of nonpayment. Certain SDI policies may reimburse the general contractor for any claims that it has to pay to lower tier claimants related to non-payment through its obligation to remove mechanic’s liens, claims made against its own bond, or some other legal theory. However, it is certainly far easier to simply send a copy of the subcontractor’s payment bond to the claimant and let the surety use its time and resources to resolve these claims.
4. **No deductible**

Although SDI deductibles are negotiable, they can range from $350,000 to $2,000,000 dollars per loss, but are typically in the $500,000 range.\(^{15}\) Furthermore, once the deductible is reached, some SDI insurance products require that the contractor bear the cost of an additional “co-pay” for another $1,000,000 to $5,000,000 in losses in the amount of 20%.\(^{16}\) The surety bonds, however, have no deductible or co-pay. In the event of subcontractor default, either to the general contractor by way of the performance bond or lower-tier claimants by way of the payment bond, the bonds provide first dollar coverage.

5. **Pressure On the Principal’s Ownership**

Because sureties typically require personal and corporate indemnity from the subcontractor’s ownership by way of a general agreement of indemnity, assets of the company and ownership are pledged to the surety as a condition for surety credit. The ownership has a vested interest in insuring operation performance and payment of the firm’s obligations on bonded projects. The ownership cannot simply shut its doors and walk away. Thus, if the subcontractor finds itself in financial peril, it will typically focus on completing the bonded jobs. This is a powerful incentive that is not found in other risk transfer mechanisms.

**F. Considerations Before Requiring Performance and Payment Bonds**

1. **Cost**

One of the two most often-cited disadvantages to surety bonds over SDI is the substantial cost of surety bonds. Premiums for performance bonds can vary based upon the risk as evaluated by the underwriter. Variables include the financial strength of the principal, the project type and size, the location of the project, the project duration, and the underlying contract. The
premium cost is calculated based upon the contract amount and generally ranges from 1% - 3% of the Contract value. Ordinarily, there is no additional cost for a payment bond if the performance and payment bond are purchased together. In recent years, subcontractor bonds appear to have grown more expensive and more difficult to obtain. Alternatively, the costs for SDI coverage is typically lower. Furthermore, sureties do not offer any sort of financial incentive (i.e., refunded premiums) if no claims are made against the bonds.

2. **Time**

The other most often-cited disadvantage to surety bonds over SDI, and the one most often bemoaned by counsel, is the perception that the surety’s investigation takes far too long. Often, the subcontractor’s default is occurring at critical point during project completion, and will significantly impact the project’s schedule. This is further exacerbated by the fact that the surety is typically the last party to have notice of its principal’s default (typically a requirement of the bond to trigger coverage), either due to the negligence of general contractor or its desire to work with the subcontractor to the extent possible. Often, the general contractor is in a position to move much more rapidly remedy the default, either by immediately supplementing the subcontractor’s forces, paying sub-subcontractor and suppliers directly, or retaining a new subcontractor. Not only may the surety take weeks or months longer than expect to complete its investigation, it may ultimately deny liability for a myriad of reasons after the investigation. SDI puts more power in the hands of the general contractor

3. **Lack of Control**

The converse to the numerous options available to the surety discussed in Section II(E)(2), above, and as further discussed in Section I(C)(3), above, is the general contractor’s lack of control over the entire process remedying a subcontractor’s default. The general
contractor may certainly suggest the avenue for the surety to take; however, the surety is under no obligation to consider any other avenue other than the most cost-effective to achieve project completion.

4. Fewer Rights of Recourse Against the Surety

SDI is bound by the traditional covenant of good faith and fair dealing implied into all insurance contracts. Therefore, the general contractor has significant legal remedies against its insurer under its contract, including potentially punitive damages, if the SDI provider fails to fulfill its obligations to the contractor. Conversely, while some jurisdictions have held sureties liable for bad-faith refusal to pay or delay in processing the obligee’s claim, not all jurisdictions have followed suit. For instance, in *Cates Construction, Inc. v. Talbot Parnters*, the California Supreme Court held that a surety’s obligations to an obligee are distinguishable from the obligations under a two-party insurance contract. Thus, in terms of bad-faith claims and punitive damages, a contractor will likely have more rights against the SDI provider.

G. Specific Considerations for Owners

Many owners do not fully understand SDI 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 that SDI gives the contractor 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 – both certainly desirable outcomes for the owner. Proponents submit that the owner will also directly, or indirectly, benefit from the higher per loss limits afforded by SDI. Some will also claim 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 bids 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 issue with SDI is that the contractor 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.

**H. Considerations for Subcontractors (as Bonded Principal)**

Subcontractors have mixed reactions to SDI versus surety bonding. A positive from their perspective is that enrollment on a SDI project may not tap their available bonding capacity or require personal indemnity. Furthermore, there is an incentive with a 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. In addition, since the contractor retains substantial financial risk for subcontractor performance, there is a disincentive to accept the additional risk of contracting with subcontractors or vendors unknown to the contractor. However, without a surety bond, their sub-subcontractors/supplier lacks payment protection from the insurer, they can be subjected to an invasive contractor prequalification process, and they have less protection against arbitrary or unwarranted default declarations.
I. Considerations for Sub-Subcontractors/Suppliers

Certainly, sub-subcontractors and suppliers prefer that their higher-tier subcontractor obtain bonds, specifically payment bonds. While on public projects the claimant will be able to seek recourse against the general contractor’s payment bond depending on whether they are a proper claimant, on private projects the lower-tier claimant is limited to a mechanic’s lien. If the claimant misses the deadline to file its lien, or the property has no equity, the sub-subcontractor or supplier may be out of recourse for payment on projects where SDI is required.

III. OTHER METHODS OF MITIGATING SUBCONTRACTOR DEFAULT RISK

A. Not Prequalifying Subcontractors is Risky Business

Before you solicit bids from subcontractors you need to make sure they are capable of completing the work, both physically and financially. While general contractors have always taken steps to pre-qualify subcontractors, such as assessing their financial situation, safety record, insurance coverage and other factors, vetting the number of subcontractors creates administrative headaches for the general contractor. General contractors have tried to streamline the process by imposing a pass/fail test in lieu of a full assessment of each bidder. To hold down costs, private construction projects are being “hard bid” and the work going to the lowest bidder, rather than the most qualified subcontractor. A key area of prequalification scrutiny is a subcontractor’s financial strength and credit history, including details like annual contract volume, sales and net worth. A financial review can spot a variety of red flags, including significant early billings on a project that are not accounted for as cash or receivables on the subcontractor’s balance sheet, which is a sign that it has to use the money immediately to cover costs on another project. Reach out to vendors to get a sense of the payment cycles and the health of their relationships with the subcontractor. Consider spot checking the subcontractor’s payments to suppliers and second-tier subcontractors, as the project progresses. 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 take a greater interest in the financial strength of their subcontractors.

**B. Letters of Credit**

A standard practice to deal with the risks that the subcontractor hired to perform work on a project will not complete it properly and pay their sub-tier contractors and suppliers is through a performance or payment bond which, as discussed further in Section __, above, is a three-party agreement whereby the surety guarantees to the obligee (general contractor) the performance of the principal (subcontractor). A less-used alternative to a surety bond is a letter of credit. A letter of credit is also an agreement between three parties, a project owner, a contractor and a financial institution issuing the letter. A bank letter of credit is a cash guarantee to the owner, who can call on the letter at any time without cause. Once called upon, the letter of credit converts to a payment to the owner and an interest-bearing loan for the contractor. A letter of credit has no guarantee of project completion, and the performance of the underlying contract has no bearing on the bank’s obligation to pay on the letter of credit. A letter of credit can be issued for any percentage of the project contract amount, but it is usually between 5 to 10%.

The banker examines the quality and liquidity of the collateral available to the bank in case there is a demand on the letter of credit. Specific liquid assets are pledged to secure bank letters of credit. Contractors who cannot qualify for a surety bond but can provide a letter of credit may not possess all the necessary capabilities to perform the work successfully to completion.

**C. Parent Guarantees**

A parental company guarantee (PCG) is a guarantee given by one contractor party’s ultimate or intermediate holding company in favor of the other contractor party to secure the performance of that party’s obligations under the contract. In construction, parent companies will give guarantees to bolster the financial credibility of their smaller subsidiary companies. The guarantee is given by the parent company to the client, and in the event that the contractor
defaults on their obligations or becomes insolvent, the parent company is required to remedy the breach or pay for the loss and expense incurred by the client.

There is no industry standard form for parent company guarantees, so parties should take care to ensure that the wording adopted properly reflects their specific requirements. The parent guarantee should contain the same rights, obligations and limitations that the contractor has under the contract. However, a parental guarantee raises a number of concerns. The parent may be just a shell or LLC that really has no assets. The parent company may be just one company in a chain of corporations. It is recommended to have the PCG issued by the entity that is ultimately in control.

D. Monitoring Programs

The general contractor is responsible for adhering to completion dates and project specifications. They retain the risk of managing their own work and also face significant risk for a subcontractor’s failure to perform according to the contract terms. Subcontractors may not be forthcoming about difficulties they are experiencing on the project. It is important to be proactive in monitoring any signs that they are experiencing difficulties or at risk of defaulting. Common signs include a sudden decrease in their workforce for a project, or failure to man the job properly. Delayed material deliveries and failing to pay their sub-tier subcontractors and suppliers on time is another common sign a subcontractor is running into problems. If you start noticing these red flags, you should address them immediately with the subcontractor regardless of whether they appear to be performing their work and staying on schedule. If you wait too long to react to a subcontractor who might be struggling, it can kick off a chain reaction that can derail the whole project.

Sit down with your subcontractor and work with them to correct the issue. Find out if they are having difficulties with one of their sub-tier subcontractors or a supplier not delivering materials on time. If the problem is cash flow, verify that the issue is not with you not paying them enough or on time in order for them to complete the work. The easiest and most cost-effective solution is to sit down with your subcontractor and discuss what options are available
and how you can assist them to get them back on track. It may be as simple as self-performing some of the work, or altering the subcontract to a labor-only contract. Make sure your contract includes provisions outlining your rights to supplement their work, suspend the subcontractor’s performance or terminate the contract. The contract should also include a right to reimbursement for any reasonable costs you incur should you have to step in and take action.

If your contractor defaults, make sure to strictly follow any notice requirements and claim procedures in the contract before you exercise your right to supplement their work or take other action. Typical construction contracts require written notice of default and a deadline for curing the default. Failure to strictly comply with the notice requirements and claim procedures under the contract may result in a loss of a claim against the subcontractor.

**E. Joint Checks**

In the construction industry, the use of joint checks is common to protect owners and general contractors from lien foreclosures by lower-tier subcontractors and material suppliers that upper-tier contractors and subcontractors have failed to pay. The use of joint checks is a device to help mitigate against an owner or general contractor being required to pay twice for the same work or materials. A construction contract should address the issue of the owner’s/general contractor’s right to issue joint checks under certain conditions, e.g., to satisfy legitimate mechanic’s lien claims or to pay critical suppliers who will only delivery C.O.D.

Many states to varying degrees have adopted what is called the “joint check rule.” Under the joint check rule, unless there is an agreement to the contrary, the party who endorses a joint check will be deemed to have received the entire proceeds regardless of how much is actually received. Thus, if a general contractor issues a joint check to a subcontractor and a lower-tier contractor for $100,000 and $90,000 is earmarked for the subcontractor and $10,000 is earmarked for the lower-tier contractor, then the lower-tier contractor should make sure that the subcontractor endorses the check first and gives the endorsed check to the lower-tier contractor for deposit into the sub-tier contractor’s account. Otherwise, if the lower-tier contractor endorses it first and the subcontractor deposits the check into its account and never pays the sub-tier
contractor, the sub-tier contractor will lose all rights it may have had to file a mechanic’s lien or a claim under the subcontractor’s licensing bond. The lower-tier contractor’s endorsement of the check is an acknowledgment of receipt of payment whether or not it actually received the payment. The presumption of payment upon endorsement of the joint check may give rise to a release of claims against the general contractor’s registration or payment bond sureties, and possibly even a waiver of a mechanic’s or materialmen’s lien rights. However, the joint check rule is usually not applicable to public works projects.

A general contractor or owner should incorporate joint check agreements into their contracts and subcontracts to avoid any potential factual disputes concerning what the parties intended. The agreement should ensure that the prime contract or the subcontract clearly spells out that the owner or general contractor may, but is not required to, use joint checks for payment to downstream parties. The agreement should provide that payments issued to a lower-tier subcontractor or supplier is merely an accommodation of payment and does not create any employer/employee relationship or contractual relationship between the owner or the general contractor and lower-tier persons or entities that are not employees of the payor and do not have a direct contractual relationship with the payor. Avoid issuing checks directly to a subcontractor or lower-tier subcontractor’s employees because these direct payments could be a factor in determining whether a worker is an employee or independent contractor.

The joint check agreement should be limited to payment for work or materials furnished after the date of the agreement and only for work and materials incorporated into the project. The joint check agreement should also contain an acknowledgement that the joint check proceeds are the property of the co-payee recipient and not the property of the other co-payee in an effort to mitigate the risk that the funds being associated with the co-payee’s bankruptcy estate, should the payee contractor or subcontractor file for bankruptcy. Finally, any payment made, either progress or final, should require completed and signed waiver and release of claim documents (discussed below). The joint check agreement should state that the endorsement of
the check constitutes an express release of bond and lien rights and is a waiver of any claims arising from the work or materials furnished by the payee.

**F. Lien Waiver and Releases**

Lien waiver and releases are commonly used in the construction industry. A lien waiver is a document from a potential lien claimant on the construction project stating that they received payment and therefore waive any future lien rights against the property for the amounts paid. When used properly, a lien waiver and release acts as a receipt of funds, protecting all parties involved in the project chain – from owners to suppliers.

Lien waivers can be conditional or unconditional, and can apply toward partial payments or final payments. A conditional waiver on a partial or progress payment states that if a claimant is paid the amount stated, the waiver is effective proof against any lien claim on the property for the amount paid. An unconditional waiver on partial or progress payment unconditionally releases all claimant rights through a specific date and for the amount stated. A conditional waiver on final payment releases all claimant rights to file a mechanics lien if they are paid to date. An unconditional final waiver for final payment releases all rights of the claimant to place a mechanics lien on the owner’s property unconditionally.

**G. Special Payment Terms**

The monthly draw process is fraught with risk. If a subcontractor fails on a project, the general contractor can suffer economic loss in many areas, including overpayment of the defaulted subcontractor and having to pay the defaulted subcontractor’s laborers and suppliers twice. Too little time and effort is spent on verifying the percent complete and the quality of the work. Moreover, poor communication between a superintendent and a project manager can lead to a subcontractor’s overpayment. A well-executed monthly draw process can help avoid payment issues, and allow the project team to focus on the most important part of the payment process, namely verifying percent complete and managing payments.

Contingent payment clauses make payment to a subcontractor contingent on some event. These clauses generally take two forms, either a “pay-when-paid” or “pay-if-paid” clause.
clauses are controversial because they purport to shift the risk of project owner nonpayment from the general contractor to subcontractors. A pay-when-paid clause is a payment clause that states that the contractor is obligated to pay its subcontractors following receipt of payment from the owner. If the Owner delays three months in paying the contractor, the contractor has no duty to pay the subcontractor during that period of delay. A pay-if-paid clause provides that a subcontractor will get paid only if the owner pays the general contractor. If the Owner never pays the contractor, the contractor has no duty to pay the subcontractor. Regarding pay-when-paid clauses, courts in most states rule that payment cannot be indefinitely withheld from a subcontractor based on a pay-when-paid provision. Instead, payment should be made to a subcontractor within a reasonable time after completion of the work. As for pay-if-paid clauses, courts in many states rule these clauses enforceable, but only if there is contractual language demonstrating the parties’ unequivocal intent that the subcontractor is to be paid only if the general contractor is paid. Some states, including California and New York, have held that pay-if-paid clauses are a violation of public policy and are therefore void. But the causes are alive and well in many jurisdictions.

IV. CONCLUSION

General contractors, and all other project participants, are in a more precarious position than they were ten years ago with regards to subcontractor default risk. As this paper demonstrates, there are numerous options available to assist with managing and mitigating subcontractor default risk. Although the risk cannot be completely eliminated, utilizing either SDI or surety bonds, in combination with effective management practices, can reduce the risk to controllable levels.

1 Ms. Beck would like to thank Mark Reagan, Griff Moody, David Hewett and Austin Neff for their input.

2 In general, surety bonds can actually trace their roots back thousands of years when, in 2750 BC, the first known suretyship contract was written on a Mesopotamian tablet. A thousand years later, suretyship was codified for the first time in the Code of Hammurabi. See “Surety Bonds Timeline,” available at https://www.suretybonds.com/edu/history.html.


6 At the time of this article, Westlaw identified over 4000 decisions that cited to the Miller act, Heard Act, or state Little Miller Acts.


8 Bid bonds are another form of suretyship commonly issued on construction projects. However, as most subcontractors provide negotiated prices, rather than bid their work, bid bonds are not addressed in this paper.


13 See id.


16 *Id.*