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Construction Subcontractor Default Insurance: A Viable Alternative to Performance Bonds?

Evaluating the Pros and Cons of SDI Insurance as a Risk Mitigation Vehicle for Contractual Performance Defaults

TUESDAY, SEPTEMBER 30, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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CONSTRUCTION SUBCONTRACTOR DEFAULT INSURANCE

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SUBCONTRACTOR DEFAULT INSURANCE (SDI)
I. OVERVIEW

SDI is (first party) insurance product obtained by GC (prime contractor, design-builder, or CM at-risk)

Insures risk of sub default by <u>indemnifying</u> GC for costs incurred due to sub default

GC can recover its "direct" & "indirect" losses from defaulting sub

- **<u>Indirect costs</u> associated with default= LDs, acceleration, extended GCs**
- **<u>Direct costs</u> associated with default= remedial costs associated with default (completing work; fixing defects), legal costs, professional costs,**

KIRWIN NORRIS

<u>"SKIN IN THE GAME" COMPONENTS</u>

Aggregate Limit for ALL losses (*e.g*., $150MM)

PER Loss Limit (e.g., $50MM)

Possible Indirect Cost SUBLIMIT (*e.g*., $5MM)

Per Loss DEDUCTIBLE (*e.g*., $500k)

CO-PAY Requirements (*e.g*., 20% above deductible up to retention aggregate)

RETENTION AGGREGATE (total deductible + co-pay requirements before fully insured)

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SUBCONTRACTOR DEFAULT INSURANCE (SDI)
I. OVERVIEW

The burden of proving that you have complied with the terms and conditions of, and that the Loss is recoverable under, this Policy shall fall upon the **Insured.**

You shall give written notice to us within 30 days from the time you become aware that a **Subcontractor/Supplier** is in **Default** of **performance** under the **Covered subcontractor or purchase order agreement** or is **Insolvent.**

In the event of **Loss**, you must submit to us a satisfactory **Proof of loss.** Submission of a **Proof of loss** must be made at the earlier of:

1. The expiration of any statute of limitation or statute of repose applicable to recovery against the **Covered subcontract or purchase order agreement** or to the **Loss**; or
2. The expiration of any right to seek recovery under any **Covered subcontract or purchase order agreement** in connection with a **Default of performance** covered herein; or
3. 10 years after the substantial completion of the **Covered subcontract or purchase order agreement.**

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SUBCONTRACTOR DEFAULT INSURANCE (SDI)
I. OVERVIEW

Our indemnification of your Loss shall be calculated as follows, subject to the provisions of this Policy and subject to the Limits of insurance:

1. Calculate the amount of the **Loss.**
2. Subtract the Deductible from the lesser of either the **Loss** or the applicable Each **Loss** limit of insurance.
3. Multiply the lesser of either the amount determined in **2.** above or the amount stated in Item 5b. of the Declarations, by the Co-payment percentage stated in Item 5a. of the Declarations.
4. Subtract the amount determined in **3.** above from the amount determined in **2.** above.

We will indemnify you for a **Loss** within thirty (30) days after we receive a **Proof of loss.** In the event you provide us with documentation that you present as a **Proof of loss** that we find to be deficient, we will notify you of the deficiencies within thirty (30) days after our receipt of such documentation. We shall make payment for a **Loss** within thirty (30) days from the date upon which we receive the information necessary to cure any such deficiencies.

You may submit interim **Proofs of loss** for **Loss(es)** that you pay over a period of time greater than thirty (30) days. If an amount would constitute a **Loss** except that the amount of the **Loss** has not been finally determined, we will indemnify you for the Interim Percentage, as stated in Item 7. of the Declarations, of the **Loss** payment which would have been payable as calculated above, after we accept a satisfactory **Proof of loss.**

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SUBCONTRACTOR DEFAULT INSURANCE (SDI)
I. OVERVIEW

PREMIUM - PASSED ON TO THE OWNER

Fixed premium amount, PLUS

*"**Experience**" premium or deposit premium - portion of premium used to govern deductible / co-pay requirements that can be returned based on no subcontractor defaults or minimal claims that deposit portion of the premium was applied to

*Owner's concern that SDI is simply hidden profit avenue for contractor based on returned premium

SUBCONTRACTOR DEFAULT INSURANCE (SDI)
I. OVERVIEW

SDI Carrier	Zurich ("Subguard")	Arch/Catlin	XL
Year Established	≈1996	≈2009	≈2012
Typical PER Loss Limit	up to $50MM	up to $25MM	up to $50MM
AGGREGATE Limit	up to $150MM	approx. 2x per loss limit (*e.g.*, $20MM per loss / $30MM aggregate)	up to $150MM
Coverage Period	up to 10 yrs	up to 10 yrs	up to 10 yrs
Client Profile	GCS with sales greater than $200MM	Mid - Size GCs (above $50MM)	GCs with sales greater than $200MM
Payment of Claim	Deductible & Co-Pay	Deductible & Co-Pay (but, Co-Pay be waived based on when loss reported, *e.g.*, 5 days)	Deductible & Co-Pay

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HYPOTHETICAL

Sub default. GC incurs **$2.5MM in damages** (direct & indirect). Proof of Loss submitted and damages validated.

SDI Policy. SDI has $500k deductible. 20% co-payment requirement after deductible met. $1MM retention aggregate.

How Claim Paid. GC responsible for first $500k (deductible). GC then then responsible for another $400k (20% co-pay of the remaining $2MM in damages), for a total of $900k (less then retention aggregate). This is the GC's "SKIN IN THE GAME." Insurer pays *$1.6MM (balance of claim).

*SDI will allow for subrogation so insurer can recoup proceeds against defaulting sub. Perhaps think waiver of subrogation endorsement.

SUBCONTRACTOR DEFAULT INSURANCE (SDI)
II. SDI IS NOT A PERFORMANCE BOND

ISSUE	PERFORMANCE BOND	SDI
TYPE OF PRODUCT	3 party agreement (surety, principal, obligee)	2 party agreement (GC and insurance co.= first party policy)
COST	Based on sub, can be 3% of contract amount (more or less)	Less than cost of sub bond (usually less than 1.5% of subcontract amounts)
UNDERWRITING	surety (not every sub has bonding capability)	GC prequalifies subs it wants to enroll (up to GC)
RECOVERABLE DAMAGES	Limited re: consequential (indirect costs)	Broader re: consequential (indirect) damages- up to sublimit
EVENT OF DEFAULT	Surety needs opportunity to investigate to determine options under bond (it is in control over default remedy)	Immediate action in the event of default (why? because GC controls remedy of default and submission of proof of loss)
DURATION / LIMITATIONS	Limited (*e.g.*, FL = 5 yrs)	Can be up to repose period (*e.g.*, FL=10 yrs)
DEDUCTIBLE	None	Large deductible and co-pay requirements
COVERAGE LIMIT	Penal sum of bond (subcontract amount)	Based on occurrence limit (higher than penal sum of bond)

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SUBCONTRACTOR DEFAULT INSURANCE (SDI)
II. SDI IS NOT A PERFORMANCE BOND

Owner not named insured under policy

- *Waterscape Resort, LLC v. McGovern*, 107 A.D.3d 571 (N.Y. 1st Dept. 2013) ("There is no dispute that the named insured on the subguard policy is PMG [contractor], and that plaintiff [owner] is not an insured under the policy. Accordingly, based on the policy's plain language, plaintiff cannot claim damages under the policy, as it is not an insured.")

SDI not a substitute for requiring GC to obtain performance bond

- *Waterscape Resort* (owner sued contractor for fraud due to subcontractor that constructed superstructure defaulting—sub wasn't enrolled in subguard; summary judgment entered against owner)

- Not every sub will be enrolled in SDI based on GC's pre-qualification standards

- Owners should still pay for protection of having GC obtain payment and performance bonds

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The Pros and Cons of SDI Policies

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Pros of SDI Policies (#1)

- #1: Lower premium costs.
  - Potential for more favorable pricing with SDI programs as subcontractor prequalification processes are improved.

Pros of SDI Policies (#2)

- #2: General Contractor remains in control of addressing the default
  - *I.e.* the party [the contractor] in the best position to mitigate the cost and delay resulting from a subcontractor's default controls the remedy.

Pros of SDI Policies (#3)

- #3: Eliminates Surety Investigation Process.
  - No investigation period by a surety after a subcontractor defaults.
    - Typically the bonding company’s duties are triggered only after a subcontractor has been declared to be in default. This takes time because the cure/default process in the underlying subcontract must be completed and surety investigations can take time.

Pros of SDI Policies

A typical Investigation Process will consist of the following steps:

- Bonding company will investigate the claim.
- Bonding company will ask for tremendous amount of information and will require review time.
- Bonding company will hire a consultant.
- Bonding company and its consultant will take project team time to gather documentation and facilitate investigation.
- Bonding company and its consultant will bid out work to be completed by takeover contractor.
- Bonding company usually represented by counsel, resulting in communication delays.

Pros of SDI Policies

- **Bonding company can then choose to:**
  - Forfeit the penal sum of the bond;
  - Tender a new subcontractor;
  - Finance the defaulted subcontractor;
  - Allow the contractor to proceed at its own discretion (at the bonding company's expense); or
  - Challenge the default and decline the demand.

- Standard bonding company defenses not at issue (defenses like overpayment, lack of notice, lack of consent to change orders.

- Bonding company may act like it is responding to a claim and then reject it after investigation, leaving project team in difficult position.

- Bad faith does not put surety at risk for damages in excess of penal sum of bond in all states.

Pros of SDI Policies (#4)

- #4: SDI insurance only involves 2 parties.
  - Insurance company will compensate the contractor for losses resulting from a subcontractor's default.
  - Usually cover first-tier subcontractors AND second-tier subcontractors—onsite subcontractors.

Pros of SDI Policies (#5)

- #5: Broader coverage
  - Coverage for indirect costs = liquidated damages, acceleration of other subcontracts and extended overhead.
    - Contractor loss not capped at the penal sum of the bond (the bond amount limits the recovery) and default insurance usually has higher limits not just limited to a particular subcontract value.

Pros of SDI Policies

- With SDI, contractor may recover liquidated damages associated with project delay

- Recovery potential up to the policy limit for any default, regardless of defaulting subcontract value

Pros of SDI Policies (#6)

- #6: Control
  - Insured contractor controls the claim process when a performance default occurs.

Pros of SDI Policies (#7)

- #7: Coverage of entities otherwise unqualified for a bond.

Cons of SDI Policies (#1)

- #1: Cost. Large deductibles (in excess of $500,000)
  - Companies providing subcontract insurance programs will typically not allow Owner to take risk of deductibles to reduce cost of insurance.
  - If there are no defaults on a project, the General Contractor will receive an additional fee/profit
  - Owner likely pays more than actual premium costs

Cons of SDI Policies (#2)

- #2: Potential conflict
  - Potential Conflict between Owners and General Contractors where defaulting subcontractor also has a claim for additional compensation due to changes or where the defaulting subcontractor claims that Owner-requested changes caused it to default.

Cons of SDI Policies (#3)

- #3: Risk
  - If a Court or Arbitrator (depending on dispute resolution process established for the project) determines that a default was improper, the coverage is forfeited.

Cons of SDI Policies

- For example, see below sample SDI language:

6. CLAIMS

a. The **Insured** bears the burden of proving that it has complied with all terms and conditions of this Policy and that the **Loss** is recoverable under this Policy.

g. The **Insured** must immediately return any payments made by the Company upon a determination by a court, arbitrator, or other legally binding determination that the **Loss** does not arise out of a **Default of Performance**.

Cons of SDI Policies (#4)

- #4: Subrogation Rights Belong to Insurer
  - Insurer will likely control subrogation rights and be entitled to first dollar recovery for (i) cost of pursuing subrogation; and (ii) coverage provided to general contractor before the general contractor receives reimbursement from any recovery from the defaulting subcontractor

Cons of SDI Policies

For example, see below sample SDI language:

7. SUBROGATION AND RECOVERIES

a. In the event of any payment by the Company under this Policy, the Company shall receive, to the extent of such payment, all of the **Insured's** rights of recovery and other remedies against all persons, entities or organizations with respect to such payment.

e. After payment of the **Loss**, any funds or salvage recovered will be paid to the Company and shared between the **Insured** and the Company in the following order:

(1) the Company will be fully reimbursed for the Company's costs of recovery, including but not limited to, attorney fees, expert witness fees, arbitrator fees and court and arbitration costs and expenses;

(2) next, if any funds remain, the Company will be fully reimbursed for the **Loss** amount the Company paid in excess of the sum of the Deductible and Co-payment Deductible Amount as listed in Item 5. and Item 6. of the Declarations, respectively; and

(3) next, if any funds remain and the **Insured** paid a Co-payment Deductible Amount, then the **Insured** and the Company will share, based on the Co-payment Deductible Amount listed in Item 6. of the Declarations, any remaining sums until the amount of the Company's payment of the **Loss** and the Company's cost of recovery have been fully reimbursed.

Sums remaining after all payments in Subparagraphs 7.e.(1) through 7.e.(3) hereto, if any, shall be retained solely by the **Insured**. The application of amounts recovered as described above applies regardless of any designation of amounts by the **Subcontractor/Supplier** or any other party.

Cons of SDI Policies (#5)

- #5: SDI does not always include time critical suppliers in coverage

Cons of SDI Policies (#6)

- #6: No subcontractor prequalification process in SDI insurance.
  - The 3 party nature of bonding relationship may help mitigate potential losses.
  - Especially true for smaller contractors that may not have the resources to investigate subcontractors on their own.

Cons of SDI Policies (#7)

- #7: Statutory Requirement
  - On public projects, SDI policies may not meet the requirements for payment bonds under the Miller Act and/or state public bond statutes.

Cons of SDI Policies (#8)

- #8: Clear legal precedent on bonding relationships. SDI insurance is less charted.
  - Well-established statutes and case law govern surety bonds in a wide variety of contexts.
  - Few reported decisions on major subcontractor default insurance disputes.
    - Likely will be in the future (*i.e.* coverage issues on private projects and litigation re the applicability of SDI on public jobs under the Miller Act).
    - Still new area.

Cons of SDI Policies

– Unclear on how judges will treat SDI issues

- One potentially positive angle in favor of SDI policies if that Contractor may be able to pursue a bad faith claim and punitive damages under SDI policy:
  - – With SDI insurance, insurer would likely be bound by the traditional covenant of good faith and fair dealing in insurance contracts.
  - – If SDI provider does not fulfill its obligations after a contractor has established a claim, it can potentially pursue an action against the insurer (and include punitive damages).

Cons of SDI Policies

- This is not the case with sureties. Surety interests have successfully opposed contractors' ability (as obligee) to recover against sureties on bad faith claims.

  » *See* e.g. *Cates Construction Inc. v. Talbot Partners*, 21 Cal.4th 28, 980 P.2d 407, 86 Cal.Rptr.2d 855 (1999) (distinguishing surety's obligations to a contractor from obligations under a two-party insurance contract and holding that a disparity in bargaining power generally is absent in **construction** performance bonds and therefore denying the contractor the right to pursue a claim for bad faith breach of contract against the surety)

Cons of SDI Policies

- **<u>Suggestions</u>**

- Pay only premium cost as a Cost of Work and establish contingency within contract pricing structure to cover deductibles in the event of a default. This removes the potential for paying an additional layer of fee.

- Obtain policy in advance of project commencement to understand any conditions on coverage, subrogation rights and risks associated with an improper declaration of default.

Evaluating Viability for a Particular Project

Considerations:

- Likely available for private projects only
- Availability may be dependent on general contractor use of subcontractor insurance instead of bonding
- Lender input is important
- Pricing structure and schedule may be an important consideration