Subcontractor Default Insurance

Presented By:
David Adelstein
Kirwin Norris, P.A.
dma@kirwinnorris.com
(954) 759-0026

Presentation Outline

I. Overview of Subcontractor Performance Bonds

II. Overview of Subcontractor Default Insurance

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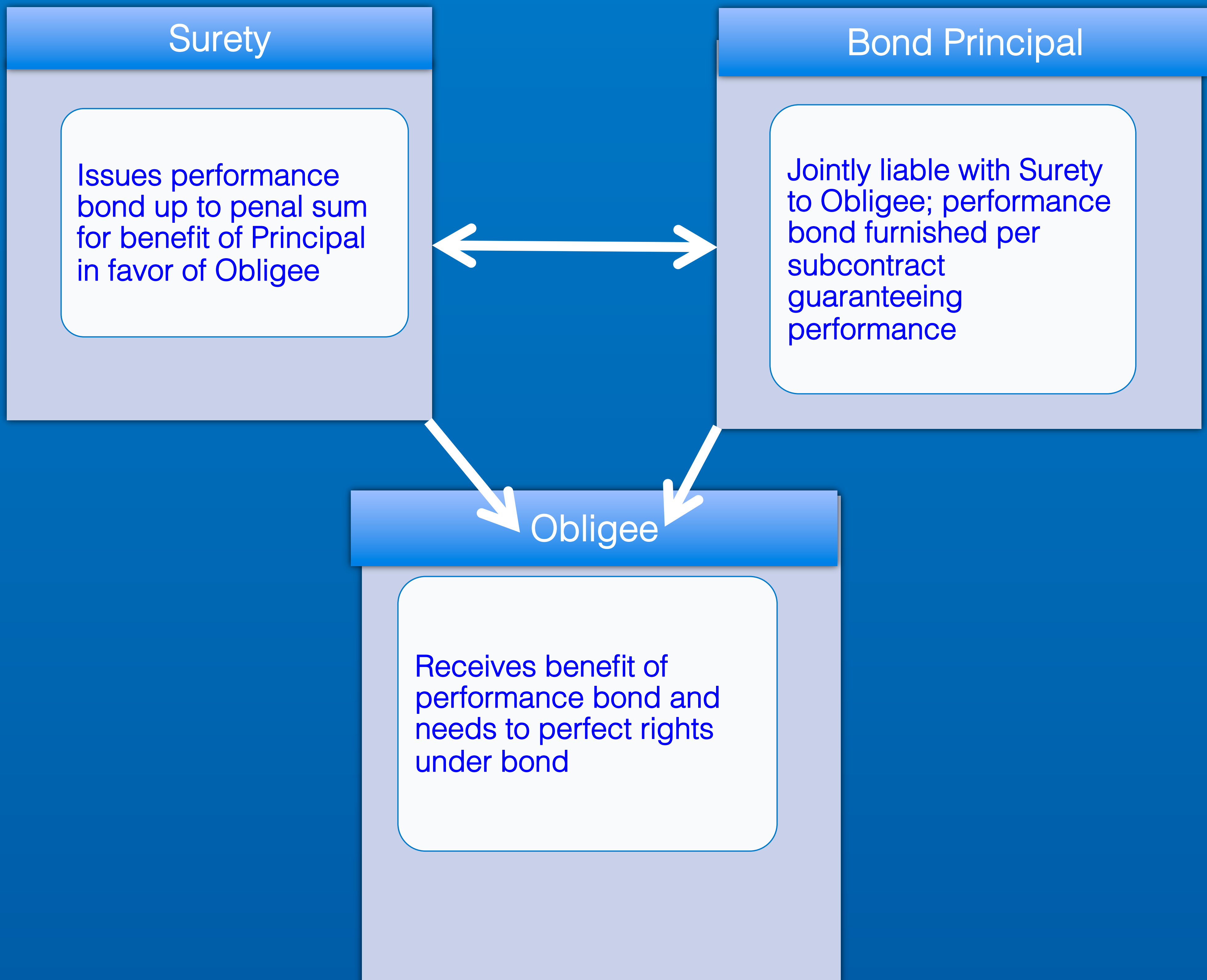
I. Overview of Subcontractor Performance Bonds



Overview of Subcontractor Performance Bonds
(Ex. of Lang. – Contractor Performance Bond)

§ 3 If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after

.1 the Owner first provides notice to the Contractor and the Surety that the Owner is considering declaring a Contractor Default. Such notice shall indicate whether the Owner is requesting a conference among the Owner, Contractor and Surety to discuss the Contractor's performance. If the Owner does not request a conference, the Surety may, within five (5) business days after receipt of the Owner's notice, request such a conference. If the Surety timely requests a conference, the Owner shall attend. Unless the Owner agrees otherwise, any conference requested under this Section 3.1 shall be held within ten (10) business days of the Surety's receipt of the Owner's notice. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default;

.2 the Owner declares a Contractor Default, terminates the Construction Contract and notifies the Surety; and

.3 the Owner has agreed to pay the Balance of the Contract Price in accordance with the terms of the Construction Contract to the Surety or to a contractor selected to perform the Construction Contract.

Overview of Subcontractor Performance Bonds
(Ex. of Lang.-Subcontractor Performance Bond)

NOW, THEREFORE, THE CONDITION OF THIS OBLIGATIONS is that, if Principal shall promptly and faithfully perform said subcontract, then this obligation shall be null and void; otherwise, it shall remain in full force and effect.

Whenever Principal shall be, and be declared by Obligee to be in default under the subcontract, the Obligee having performed Obligee's obligations thereunder:

1) Surety may promptly remedy the default subject to the provisions of paragraph 3 herein, or

2) Obligee after reasonable notice to Surety may, or Surety upon demand of Obligee may arrange for the performance of Principal's obligation under the subcontract subject to the provisions of paragraph 3 herein.

3) The balance of the subcontract price, as defined below, shall be credited against the reasonable cost of completing performance of the subcontract. If completed by the Obligee and the reasonable cost exceeds the balance of the subcontract price, the Surety shall pay to the Obligee such excess, but in no event shall the aggregate liability of the Surety exceed the amount of this bond. If the Surety arranges completion or remedies the default, that portion of the balance of the subcontract price as may be required to complete the subcontract or remedy the default and to reimburse the Surety for its outlays shall be paid to the Surety at the times and in the manner as said sums would have been payable to Principal had there been no default under the subcontract. The term "balance of the subcontract price" as used in this paragraph shall mean the total amount payable by Obligee to Principal under the subcontract and any amendments thereto, less the amounts heretofore properly paid by Obligee under the subcontract.

I. Overview of Subcontractor Performance Bonds

- Performance bonds require:

  1. Unequivocal declaration of default – principal defaulted on obligations of contract

  2. Notice that surety must remedy default pursuant to terms of bond

Ex. *L&A Contracting Co. v. Southern Concrete Services, Inc*., 17 F.3d 106 (5th Cir. 1995); *accord North American Specialty Ins. Co. v. Ames Corp*., 2010 WL 1027866 (S.D.Fla. 2010)

I. Overview of Subcontractor Performance Bonds

ISSUE	PERFORMANCE BOND
TYPE OF PRODUCT	3 party agreement (surety, principal, obligee)
COST	Based on sub, can be 3% of contract amount (more or less)
UNDERWRITING	Surety (not every sub has bonding capability); General Agreement of Indemnity
RECOVERABLE DAMAGES	Limited re: consequential (indirect costs)
EVENT OF DEFAULT	Declaration of default; notice to Surety to remedy; Surety needs opportunity to investigate to determine options under bond (it is in control over default remedy)
DURATION / LIMITATIONS	Limited (e.g., FL = 5 yrs)
DEDUCTIBLE	None
COVERAGE LIMIT	Penal sum of bond (subcontract amount)

II. Overview of Subcontractor Default Insurance

How do you address issues of

a) bonding capability and capacity of subs;

b) high premium cost built into sub bids/ contracts;

c) declaration and notice requirements to sureties; and

d) surety's investigation time??????

*SUBCONTRACTOR DEFAULT INSURANCE ("SDI")

II. Overview of Subcontractor Default Insurance

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

- This means GC is beneficiary / insured of SDI policy

- 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> = LDs, acceleration, extended GCs

    - <u>Direct costs</u> = remedial costs associated with default (completing work; fixing defects), legal costs, professional costs

II. Overview of Subcontractor Default Insurance

- SDI triggered by subcontractor default per terms of subcontract
- GC (insured) submits proof of loss with back-up proving the subcontractor default and damages
- SDI required to indemnify GC for subcontractor default (subcontract balances must be exhausted first…e.g., back-charges)
- If default proven to be improper, no SDI coverage and GC required to return proceeds

II. Overview of Subcontractor Default Insurance

- SDI is designed for GC (insured) to have SKIN IN THE GAME

- SDI's SKIN IN THE GAME components ensure the product is designed to address catastrophic sub defaults versus minor or inconsequential defaults

- SDI's SKIN IN THE GAME components ensure GC has solid sub pre-qualification process and manages subs and sub defaults

- *Note*: Performance bond does not have SKIN IN THE GAME components

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

<u>AGGREGATE Limit</u> for ALL losses (*e.g*., $150MM) (given year, given project)

<u>PER Loss Limit</u> (e.g., $50MM)

Possible Indirect Cost <u>SUBLIMIT</u> (*e.g*., $5MM)

Per Loss <u>DEDUCTIBLE</u> (*e.g*., $500k)

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

<u>RETENTION AGGREGATE</u> (total deductible + co-pay requirements before fully insured)

II. Overview of Subcontractor Default Insurance

- Declarations page should tell you:

  - policy period

  - aggregate limits of insurance

  - per loss limits

  - submits

  - co-pay percentage

  - retention aggregate

II. Overview of Subcontractor Default Insurance

Certain exclusions (examples):

-war risks

-Nuclear risks

-if sub has performance bond and GC is obligee

-fraudulent acts

-defaults prior to policy period (unless SDI is renewal policy)

-subcontracts acquired from other entities

-bodily injury

-professional services

III. How Subcontractor Default Insurance Works

Example of how premium typically applies:

Hypo: GC subcontracts $300MM per year to subs. GC typically passes SDI premium cost to owner as <u>fixed</u> percentage. Assume 1.25% ($3,750,000). Of this amount, assume .4% (or $1,200,000) is premium cost for insurance. This means .85% applies to administering policy (assume .25% or $750,000) and as a reserve to fund a loss or, alternatively, serve as a reward (assume .6% or $1,800,000)

*Objective is that 1.25% is LESS than requiring subcontractor performance bonds.

III. How Subcontractor Default Insurance Works

Example how claim typically works:

Sub default. GC incurs **$5MM in damages** (direct & indirect). Proof of Loss submitted and default and damages validated.

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

How Claim Paid. GC responsible for first $500k (deductible). GC then then responsible for another $900k (20% co-pay of the remaining $4.5MM in damages), for a total of $900k (less then retention aggregate). This means GC is responsible for $1MM (retention aggregate). This is the GC's "SKIN IN THE GAME." Insurer pays $4,000,000 .

*SDI will allow for subrogation so insurer can recoup proceeds against defaulting sub.

III. How Subcontractor Default Insurance Works

Pavarani Construction Co. v. Ace American Insurance Co., 2015 WL 6555434 (S.D.Fla. 2015) –

$25MM to remediate structural subs defective workmanship. GC received payment and worked out deal with SDI to pursue sub's CGL for resulting damage. CGL carrier argued other insurance provision (policy will operate as excess over any other available insurance). Court dismissed CGL carrier's argument as subguard and CGL insure different risks and other insurance provision applies when insurance deals with same subject matter, risk and interest.

IV. Subcontractor Default Insurance 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; subs have bonding capacity)	GC prequalifies subs it wants to enroll (up to GC) even those that could not get surety bond
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)

V. Positives and Negatives of Subcontractor Default Insurance

Pros	Cons
Lower premium costs (less than performance bonds) – more favor pricing can come through experience and prequalification process	Not a dollar for dollar reimbursement – SKIN IN THE GAME components
GC, not surety, controls default remedy and GC best position to control and remedy default – eliminates surety investigating default	Improper default means contractor needs to reimburse carrier (say Court finds default of sub improper)
Broader coverage than performance bond	Conflict may arise since owner not insured; also, sub may have claims that are owner-driven
First party policy of indemnity – quicker reimbursement	Insurer will have and want to retain subrogation rights to recoup paid out proceeds
Enrollment of subs that cannot obtain bonds	Prequalification is only has good as GC's program
Profit component (risk/reward of SDI coverage)	Less clarity regarding Court's interpretation of SDI application and coverage
Does not tie up sub's bonding capacity	Typically designed for larger GCs