Aon Business Unit
Construction Services Group

Dispelling the Myths of Subcontractor Default Insurance

Since the introduction of Subcontractor Default Insurance ("SDI") in 1995, there has been a considerable discussion and controversy over what the product covers and the impact it has for owners, lenders, general contractors and subcontractors. Over the years a number of people have provided their thoughts and opinions of the product, however in many cases this opinion isn't always based in fact. As a result, there is a great deal of misinformation as it relates to this growing insurance product, particularly in the subcontractor community.

As the leading provider of both surety bonds and SDI, both in Canada and globally, Aon has developed this discussion paper in order to dispel a number of the most common myths regarding the SDI policy that have evolved over the years. The intent of this document is not to act as a sales pitch for the product, but to ensure that the construction community has accurate information, from which to base their business decisions on.

Myth 1: SDI makes it easier for a general contractor to default a subcontractor

Perhaps the biggest misconception as it relates to SDI is that the use of the product somehow makes it easier for the general contractor to default a subcontractor and draw upon the policy to bring in a replacement trade. The reality is that default of a subcontractor has nothing to do with a general contractor's choice of risk management tools. Whether they employ SDI, surety bonds, letters of credit or the contractor's decision to self-insure, the ability to default a subcontractor is governed by the underlying subcontract. Nothing more. Just because a surety bond is in place, doesn't mean that a general contractor still can't place a subcontractor in default; terminate their contract and move on to another trade.

SDI is simply a tool to mitigate and address potential losses that result once a subcontractor has been placed in default. While it is true that a general contractor doesn't have to prove a default to the insurer, a subcontractor still has their rights under their subcontract, which should clearly spell out what constitutes a default. Should a court later determine that a trade was improperly defaulted, not only could the general contractor be subject to pay damages, they would be faced with the prospect of repaying the insurance company for any advanced funds given the default never occurred.

Myth 2: The right of subrogation by the insurance company can expand the contractual obligations of a subcontractor

Subrogation is a common term when it comes to insurance products and can be defined as follows:

- The substitution of one person in the place of another with reference to a lawful claim, demand, or right, so that he or she who is substituted succeeds to the rights of the other in relation to the debt or claim, and its right, remedies, or securities

Basically, the right to subrogation gives the insurance company the right to "step into the shoes" of the general contractor for the purpose of pursuing reimbursement from the defaulting subcontractor. In this situation, the insurance company has no greater rights than the general contractor and a subcontractor would still have the same defenses available to them. The fact that the policy provides potentially broader coverage to the general contractor does not mean they can look to the subcontractor to recover costs that were outside of what they would have otherwise been responsible for.

As a result, any costs that an insurance company could recover as a result of their right to subrogation, could also be recovered by the general contractor, regardless of the performance security option in place (bond, letter of credit, SDI, etc.)

Myth 3: General contractor's failure to follow prequalification procedures is cause for the insurance company to deny a claim

Under an SDI policy, the insurance company is relying upon the general contractor's prequalification procedures. There is an expectation that the insured will endeavor to follow these practices and failure to do so may be grounds for the insurer to cancel a program on a go-forward basis. That said, the policy language explicitly states that "cancellation of this policy shall not affect coverage under this policy for loss arising out of a default of performance under any covered subcontract or purchase order agreement executed during the policy period prior to the date of cancellation". As such, previously enrolled subcontractors remain covered under a SDI policy. This would be akin to a surety company's decision to no longer issue bonds in support of their client. Previously issued bonds remain in force despite the go-forward cancellation.

Myth 4: The general contractor is unable to prequalify a subcontractor effectively

While other forms of performance security may have an edge when it comes to experience in evaluating the financial strength of subcontractors, the vast majority of those contractors with SDI policies in Canada have individuals dedicated to prequalification, typically with significant accounting, finance, or surety experience. As a result, general contractors are certainly capable of assessing the financial strength of a subcontractor.

An important part of the prequalification process under SDI is an assessment of operational capabilities. While other forms of security may take a high level overview of operations, a general contractor is typically the best party to understand the operational capabilities of a subcontractor. Given the large deductible and co-pay requirements that put the contractor's own funds at risk, an insured is more incentivized and engaged in the process than they would be under other forms of security.

Myth 5: SDI remains a new and untested product

Relative to alternative products such as surety bonds and letters of credit, SDI remains a relatively new product and it is true that the product has a limited precedence in the court system, particularly as it relates to claims payments. Part of this can be attributed to the inclusion of an arbitration provision in the underlying policy language, which a general contractor can turn to in the event of a dispute. This helps limit the need to rely on the courts to resolve payment issues.

Although a new product, the fact remains that as of spring 2012 there had been in excess of 1,600 claims under SDI policies since the inception of the product. To-date, not only has a general contractor not brought action in the courts against the insurer, no general contractor has seen the need to turn to the arbitration provision to resolve a dispute. In addition, due to the sizable deductibles and co-pay requirements, there remains significant incentive for the insured to handle potential default issues outside of the formal legal process, resulting in a proactive and expedient process.

While the policy does remain untested in the courts, this points to a policy language that is performing as it was intended.

Myth 6: SDI provides protection for the general contractor's own work

The intent of SDI is to provide protection to the insured against the impact of subcontractor failure. The policy does not provide protection to third parties against the performance of the prime contractor. Given that a buildings contractor will subcontract in excess of 80 percent of a project's scope, there are those who feel that an insurance product that addresses the risk of subcontractor failure provides sufficient coverage. That said the fact remains that a portion of the project remains at-risk in the event of the failure of the prime contractor to address self-perform work or general conditions.

While there are certainly project owners who will forego prime contract security in an effort to limit costs, in many cases, other forms of security are still provided by the general contractor to address this exposure. This can come in the form of a traditional performance bond, a low penalty performance bond, letters of credit, parental guarantee, increased retainage or other risk management tools.

Myth 7: SDI provides payment protection to subcontractors

Unlike the coverage available under a traditional labour and materials payment bond, SDI does not provide assurance of payment protection for first tiered subcontractors. Keep in mind, the fact that a general contractor has chosen to cover a project under their SDI policy does not mean that they still haven't provided security to the owner in the form of a payment bond or some alternate form of security. The key point here is that subcontractors should understand what security is in place on the jobs they are looking to tender and the reputation of the contractor they are working for. Counterparty exposure is a key risk facing every business and is one that should be looked at.

The simple omission of a payment bond doesn't necessarily mean there is no protection available for subcontractors. Many owners, should they choose to forego a surety bond, will look at alternative security, such as retainage, letters of credit, parental guarantees and more to ensure the general contractor continues to honour their responsibilities. Subcontractors also maintain their lien rights in most situations, providing strong incentive for payment. In addition, the role of third party consultants and their oversight of the payment process continues to help ensure payments flow downstream to subcontractors. Finally, the introduction of third party payment management software such as Textura CPM is helping to provide further transparency and assurance of downstream payments.

While a subcontractor cannot claim against an SDI policy, the general contractor does have the ability to use the proceeds from the policy to satisfy downstream payments to tiered subcontractors, provided the direct subcontractor or supplier is in default of their contractual obligations. When combined with their lien rights and the general contractor's need to vacate liens, this gives a level of payment assurance to tiered subcontractors.

Summary

Subcontractor Default Insurance is a tool that is gaining in popularity amongst the general contracting and owner communities, with an ever increasing number looking at the product to address their subcontractor exposure. SDI offers an alternative to some of the more traditional security options and as it continues to grow, the subcontractor community will encounter this program with greater frequency. We encourage subcontractors to make decisions that are in the best interest of their organization, but when sourcing information, it is imperative that they look at the underlying motives behind those parties supplying the information. As with any corporate decision, care should always be taken to ensure you have the correct, unbiased facts.

As one of the largest stakeholders in the surety industry and the primary broker for 95 percent of SDI in Canada, Aon is uniquely positioned to provide insight into both industries. As your trusted advisor, we have an obligation to provide all our clients (general contractors, subcontractors and owners) with factual information as it relates to any insurance related product to assist them in making decisions that are in the best interest of their business.

This publication contains general information only and is intended to provide an overview of coverages. The information is not intended to constitute legal or other professional advice. Please refer to insurer's policy wordings for actual terms, conditions, exclusions and limitations on coverage that may apply. For more specific information on how we can assist, please contact Aon Reed Stenhouse Inc.

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