

Contractor & Subcontractor Default Insurance

Prepared

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Terms of Reference

For brevity we have included the following abbreviations:

GC = General Contractor

O = Owner

S = Subcontractor

S(DI)/SDI/DI – The Contractor Default Insurance Product.

SP = Supplier

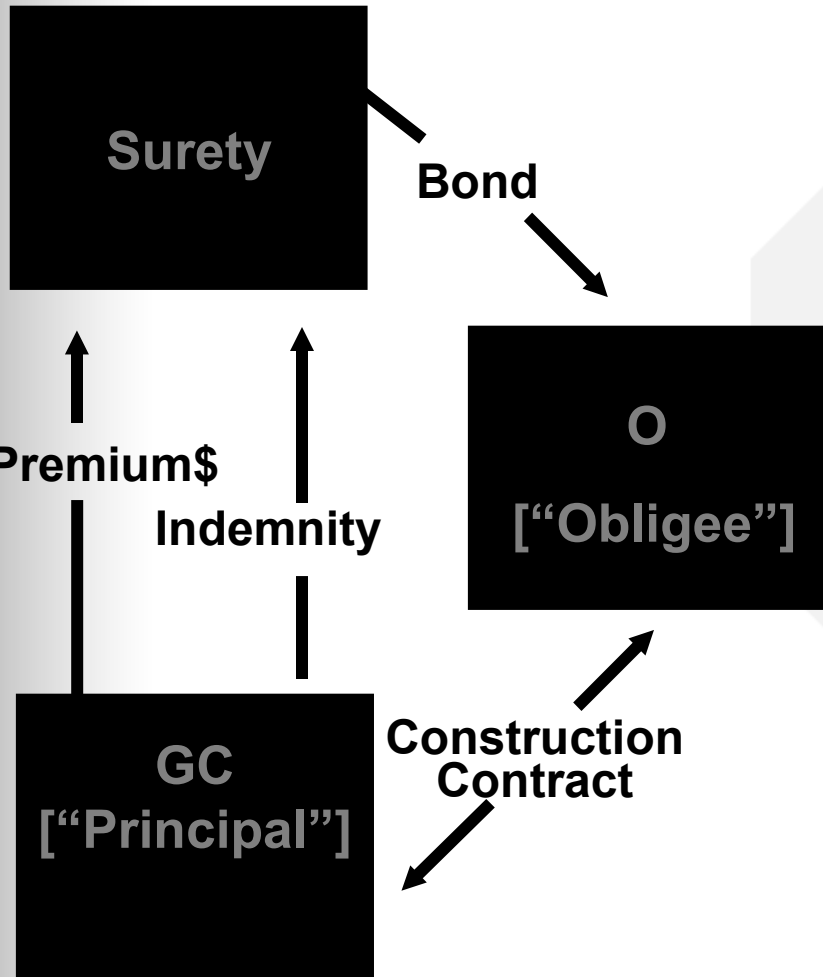
LD = Liquidated Damages

WIP = Work in Process

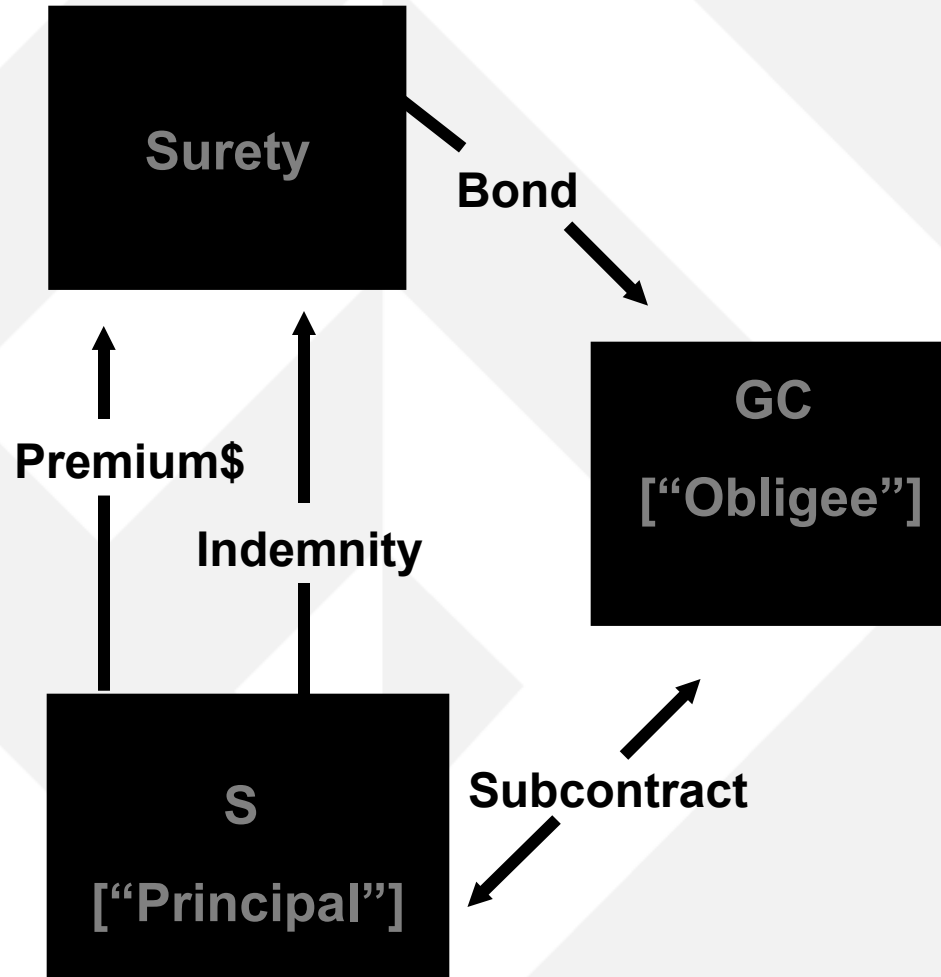
Surety Overview



Surety Bond Tier One



Surety Bond Tier Two



Surety Overview

After a default triggering Bond, Surety can:

- Forfeit bond penalty
- Finance Completion (using principal/other)
- Tender new contractor
- Finance Completion by Obligee.

Surety Overview

Obligee can recover:

- Reasonable cost of completing work.
- Balances owing to S/SP.
- Lost rental income – delay.
- Legal fees – defence of lien claims.
- Work/Defect rectification costs.
- Lost Profits
- Liquidated Damages.

Surety Overview

Surety Protection:

- Subrogation (recovery).
- Indemnification


Surety Overview

Pros

- Well understood, widely used.
- Precedent
- Prequalification
- Non cancelable
- Obtainable by good number of contractors.

Cons

- Delays – conditions precedent, investigation, indecision.
- Conflict of interest.
- No control by obligee.

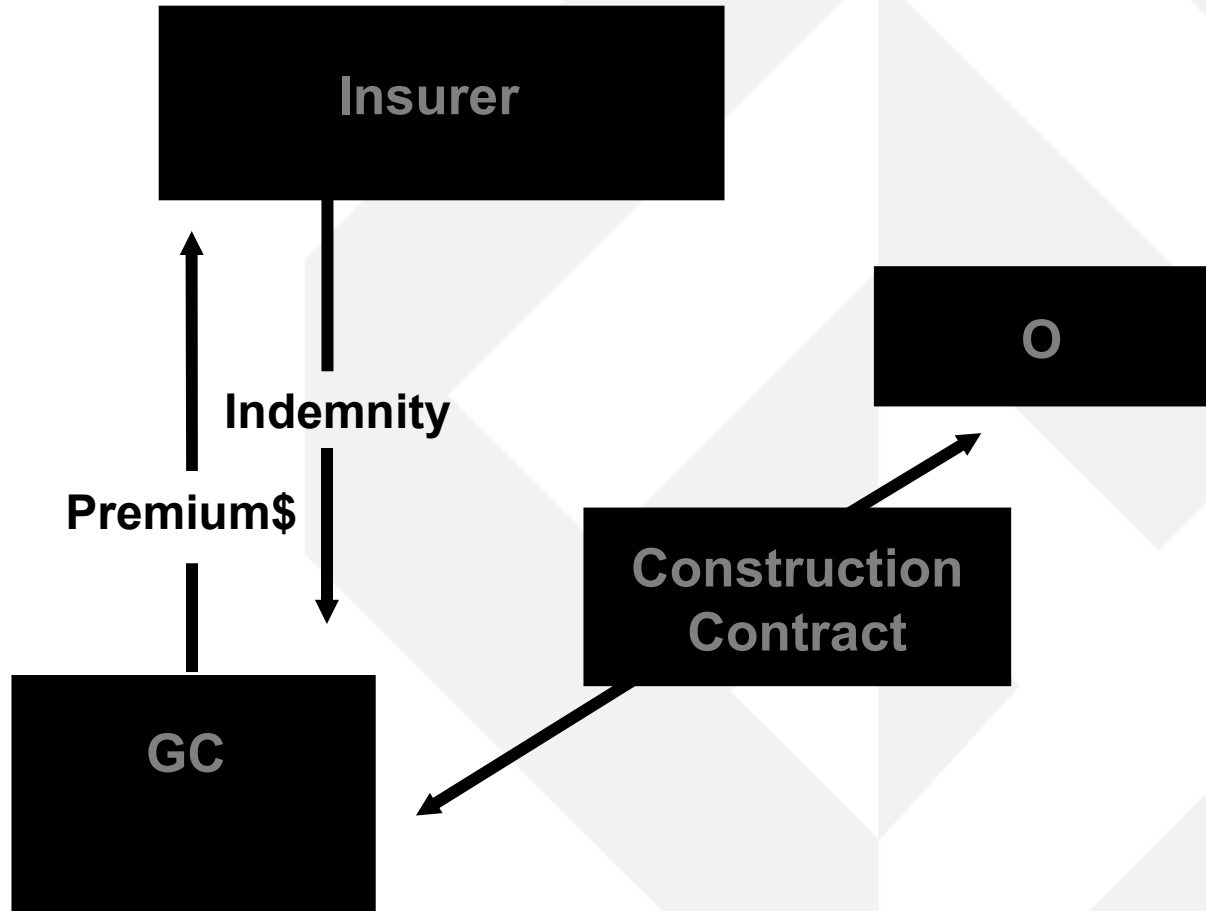


Contractor/Subcontractor Default Insurance

What is Contractor/Subcontractor Default Insurance

- *An insurance policy* not a surety bond.
- Protects Owners (O) and General Contractors (GC) from GC/Subcontractor (S) non performance.
- *Alternative* to Surety Bonds.

(S) D I STRUCTURE



What is Contractor/Subcontractor Default Insurance (S)DI

- Provided policy requirements followed provides *indemnification* for losses in event of GC/S insolvency.
- Excludes misrepresentation; fraud/dishonesty; default prior to coverage; material breach of warranty by GC (e.g. failure to cease awarding when default known); contracts acquired from other entities; nuclear/war/hostility; professional services of insured (Design-Build, CM services require specific attention).

What is Contractor/Subcontractor Default Insurance (S)DI

- On default – O/GC required to secure replacement trade and fund cost.
- Policy provides advance on costs in form of indemnity – repayment of contractor costs.
- Main Insurer – Zurich North America, limited competition.
- Covers all subcontracts on a blanket basis (incl. SP/purchase orders)
- Can cover lower tier “sub sub” but generally not due to lack of control.

What is Contractor/Subcontractor Default Insurance (S)DI

Covered costs include:

- Cost of completing SC contractual obligations
- Incurred Legal Costs
- Correction of defective and non conforming work.
- Investigation, adjustment, defense of disputes of qualifying losses.
- Indirect costs – LD, job acceleration costs, extended overhead (separate sublimit).

What is Contractor/Subcontractor Default Insurance (S)DI

- GC purchases to insure S performance on all prime contracts.
- Owner purchases to cover GC and all first tier S on a specified project.
- Large Owner conceivably could purchase on all projects contemplated over a given period of time.

Main Reasons to buy (S)DI

- *Potential* Premium/Cost Savings
- Greater control in directly managing performance of Construction parties.
- Mostly large contractors or large owners that do not wish to wait for surety response.
- Two party relationship – no need to deal with S' own surety.

What is Contractor/Subcontractor Default Insurance (S)DI

- For SDI Coverage applies on blanket basis to all subcontracts/purchase orders signed and all new projects begun after policy inception.
- Scope can include materials suppliers.
- Once notice of default given, all associated costs directly or indirectly are covered.

SDI vs. Surety

SDI

- Two party contract
- Insurance Policy
- Insured manages risk of S default
- Large deductibles -
 - Upper Tier Coverage
 - Anticipates losses
- Subrogation recovery options.

Surety

- Three party contract
- Surety Bond
- Surety provides subcontractor review
- No deductible – 1st dollar coverage
- Not Insurance – recoverable through indemnities.

SDI vs. Surety

SDI

- Introduced 1996
- No jurisprudence
- Aggregate Limit applies excess of the deductible and co-payment provisions.

Surety

- Over 100 years old.
- Jurisprudence and case law widely available.
- Limit applies from first dollar.

Owner Viewpoint

Benefits

- *Premium is usually less than bonds.
- Possible replacement of exhausted contractor bond limits.
- Possible avoidance tool by contractor of using bond limits.

** GC charged cost to O may be higher due to self insurance cost allocation (deductible/co-payment) and administration charge.*

Drawbacks

- No control over S selection.
- *SDI does not help O when S fails.
- Limited competition: Insurers.
- Risk of “bid driven” decisions to appoint S, albeit controlled by criteria.
- **No benefit/control over premium credits payable to GC for good claims experience.
- Owner still needs security around GC default and should try and get some sort of “insurable interest” status in SDI in such an event.

**Some O have obtained a covenant that GC will only deal with trades qualified under SDI.*

*** Potential opportunity to be more competitive against other GCs?*

Contractor Viewpoint

Benefits

- Deal with own Insurer vs. collecting from defaulted S surety.
- Opportunity to benefit financially from good prequalification (risk?) management.
- Improved due diligence.
- No time restriction after project completed.
- Follows subcontract promises including long term warranties and statutory requirements governing work.
- Direct claims control.
- Lower (perceived?) cost due to deductible/co-payment structure and lower insurer involvement in subcontractor prequalification.
- No savings if no default on surety bonds. Substantial savings if no defaults on SDI.
- GC rewarded for good loss record.
- Potentially broader coverage for indirect default related costs.
- Allows for use of S that may not have bonds.
- One Insurer recently included “bid bond” style coverage on all bids furnished to the GC. Trigger – default on bid by low bidder. Reimbursement – 10% of difference between low bid and second-place bid.

Contractor Viewpoint

Drawbacks

- Too new – no jurisprudence
- Wait and see.
- Prefer to retain S default risk to be more competitive
- Increased administration – S prequalification.
- Increased administration – claims mgt.
- Only Partial risk transfer.
- Indemnity wording – GC sustains up front costs.
- Surety confirms S financial strength – SDI does not.
- 0 protection for “sub sub” and suppliers of defaulted S as there would be under L&M bond.
- Only losses covered are those of Named Insured.
- Limits may be insufficient to cover loss – if blanket. Project specific should be explored on larger jobs.
- Suitable to large contractors, not for all
- Satisfied with Surety.

Surety Viewpoint

SDI	BONDS
Definitions Vague	Terms and Conds. Understood
Untested in court	Significant case law.
Deductible & Co-payment before coverage	First Dollar coverage.
Insured pays first losses, indemnified by Insurer 30 days from proof of loss.	Surety Pays losses after investigation and seeks indemnity.
Insured determines acceptability of S.	Surety provides prequal. Services.
Cover can be void if policy requirements not met.	On execution – bond stays intact.
Can be cancelled by Insurer, not O or GC.	Non cancellable.
Limited Risk transfer	Risk transfer to Surety
Policy Limit (Blanket) – project specific available. May restrict amount.	50 or 100% bonds available on project.

Surety Viewpoint

SDI	BONDS
Multi year policy (usually 3 years).	Per Contract provisions.
Insured prohibited from disclosing existence of insurance contract to S and SP. (SF – doubtful – did not see this in wording.)	S responsible for procuring own bonds.
Admin burden re S prequal. review.	Admin by Surety.
Claims During policy period – defective work after expiry not covered. (SF – to verify).	Bond continues to protect until time for filing suit as stipulated in contract, bond, statute of limitations runs out.
S & SP may not make a claim	S and SP are provided payment protection.
O/GC must manage completion of contract then file claim.	Surety completes, arranges for or pays contract completion to amount of bond penalty.
Covers all S	Those for whom bonds required.
Cost - .3-1% of subcontracted values	Usually 1% or less of bonded values.
Time coverage follows subcontract.	Claims timing affected by bond language.

Subcontractor Viewpoint

- GC require S to submit WIP, audited financials for analysis to qualify.
- Considered by S as confidential financial information – subject to misinterpretation and affect on ability to do business. “Word of mouth” fears.
- Some S prefer screening within realm of Surety.
- Damages to other subcontractors/suppliers as result of default not covered without effecting a lien.
- Weitz company allows subcontractors the option of supplying information or obtaining bonds.
- Evaluation should include financials, WIP, past performance, trade references, industry involvement.

SDI Coverage Overview

- Rarely single project – usually blanket coverage
- Up to \$50-\$100MM limits available.
- Project specific limits hard to obtain.
- Cancellation permitted by Insurer
- If cancelled, still covers S that were enrolled before cancellation.
- Deductible – usually in \$500,000 -750,000 level.
- Strict financial criteria re S pre-qualification
- No coverage on S if criteria not met.
- If GC has to use an S that does not qualify, can still cover off exposure through LOC/Bond.
- Pre-existence of a bond, vitiates SDI cover on S.

Who buys (S)DI?

- Large Contractors & Sophisticated Owners
- Each seeking 1) control and 2) savings.
- Customers that have been frustrated by Surety response to default.
- GC with own economic project completion goals.
- Preference to use own Insurer.
- In 2001 Zurich had over US\$20BN of S volume insured.
- It grew 400% in 1997; 45% in 1999; *130% in 2000
- Mostly GCs in Commercial Buildings
- Mostly GCs that have traditionally bonded subs and with \$100MM - \$2Bn in subcontractor volume.
- 15-20 of US top 50.

* Likely due to surety withdrawals after commercial bond losses.

Who buys (S)DI?

- EllisDon
- Turner
- Skanska
- Barton Malow
- Bechtel
- PCL
- J.A. Jones
- Weitz
- Haskell
- Webcor
-and others....

Note: We believe Aecon may have also purchased the coverage but have not confirmed.

Example Cost Structure of SDI

Subcontractor Volume	\$200,000,000
Maximum Premium	\$ 1,700,000 (.85%)
Experience Premium	\$ 900,000
Minimum Premium	\$ 800,000 (.40%)

- Negotiable – varies per GC profile and volume of subcontracted work.
- Minimum & Maximum Premium with Experience Premium being difference.
- Purchaser pays Maximum – usually less than 1% of total subcontracted values.
- The high end of cost is usually less than cost of bonds (recognizes significant deductible and co-payment) and decreases with good experience.
- Example above – Experience Premium is “at risk” amount depending on claim payments. If 0 claims – the low end of premium = final cost. If costs equal the high end cap, that is the maximum cost. Intermediate experience results in intermediate cost. Policies also have a deductible and co-payment provision.
- Underwriting focuses on O and/or GC capability rather than S. Relies on O and/or GC ability to manage S selection.

Example Cost Structure of SDI

- If there are no losses, entire “Experience Premium” returned to GC. In example above - \$900,000 returned.
- Loss Example based on above premium structure, \$1MM default:

Assume Limit:	\$20,000,000
Assume Deductible:	\$500,000
Co-Payment:	20%
Insured Share paid out of Experience Premium:	\$600,000 (\$500,000 + 20% of next \$500,000)
Insurer Share:	\$400,000
Remaining Experience Premium:	\$300,000 – reimbursable if no further losses.
<i>Note – If additional losses erode remaining experience premium Insurer pays 100% of remaining losses to the policy limit.</i>	

Market Availability/Options

- Zurich is the main market offering SDI coverage through its Subguard brand.
- As the main carrier there is a confidentiality risk although they do include a confidentiality statement in the wording.
- As the main carrier Zurich could decide to discontinue in a bad year. They have done on “run-of-the-mill” insurance.
- There seems to be need for competition but few takers.
- Chubb a possibility, was rumoured to be developing a product.

Alternative Market Options

Captive and Rent-A-Captive

- Contractor financial capacity could suit a captive insurance structure.
- Additional financial benefit could possibly be achieved by “reinsuring” at least the deductible/co-payment into own Captive, if not Self Insuring entire limit.
- Canadian Licensing can be obtained through “fronting” for a fee by Domestic licensed insurers.
- Reduces risk of “information sharing” within same Insurer as others.
- Potential competitive advantages financially.

Credit Insurers

- The SDI product applies similar methods as a Credit Insurer would, except the subcontractor selection is controlled by GC.
- Credit Insurers may be able to collaborate in screening – “best of both worlds” – contractor manages “experience” and Insurer “financial screening”.

Need to Know - SDI

- Joint ventures can be included if approved by Insurer.
- No notification of new S, change orders, delays, unbondable S.
- Cancellation Rights – non payment of premium, significant change in GC structure, repeated violation of qualification procedure.
- Coverage continues to apply for covered S after inception and before cancellation.
- Specific projects can be insured but not specific S.
- GC can separately bond an S, rendering SDI inapplicable on the bonded S.
- Coverage responds over Design S professional liability insurance.
- GC can still use a defaulted S to complete work, if deemed most efficient way to mitigate loss.
- Rates can be guaranteed 3 years and after first year have been guaranteed into 4th.

Conclusions

(S)DI is a worthwhile alternative to consider as part of a sophisticated Owner's or large General Contractor's Risk Management and Insurance portfolio.

Surety Bonds continue to have a place as Security around the General Contractor and perhaps major trades.

As the coverage is relatively new, it seems a broad wish list of reasonable coverage features should be presented to the Insurer for consideration, with a goal to achieving minimal Insured: Insurer interaction once coverage is in place. Negotiation of coverage should be in the client's favour. Alternative markets should be contemplated.

If this is the first time considering the coverage consider it on a single project or portfolio before wide application. Like any new system, it is better to *test* it's suitability and iron out the bugs, before widely implementing it.

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Reference Materials

We used various publicly available materials to complete this presentation. The following is a list of reference materials:

Powerpoint – Minnesota Construction Lawyers on Minnesota Construction Law – 11/13/2001

“Subguard” Subcontractor insurance – What is it? Is it an appropriate alternative to Surety Bonds? – Noteboom, L.J.- Leonard, Street and Deinard – Attorneys.

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IRMI.com – Bonding Tips and Tactics : Contractor Default Insurance – Neuschaefer, R – Robert Harris Insurance Agency, Inc. October 2001

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Fenn & Fenn Insurance Practice Inc. – file records.

Other contributors – names withheld by request.