The following is the second installment in a three-part series on construction risk finance. Mark Morris, SVP, Lockton Construction Risk Finance, is joined by Justin VanOpdorp, SVP, Manager of Lockton’s Quantitative Analysis Group, and Tom Miller, SVP, and Unit Manager, to discuss subcontractor default and the impact on general contractors and the business of construction.

No one wins when a subcontractor fails to perform according to the terms of its contract. Adverse financial repercussions impact all parties involved, including the project owner, the general contractor, the subcontractor and, if there is one involved, the bonding company.

Managing subcontractor risk is far different than work that is self-performed, and in today’s environment, the stakes involved in managing subcontractor risk are higher than ever before. Current economic conditions have resulted in a downturn in the number of construction projects, which puts significant strain on the balance sheets of both general contractors and subcontractors. As a result, both strive to lessen that strain and keep their respective work forces in place by acquiring new work, in a number of cases at less favorable financial terms than in previous years, which can lead to a compromised ability to perform on the part of subcontractors and general contractors. Also, increased litigation and class action suits over construction defects have significantly enhanced the legal liability of general contractors and subcontractors alike.
As a result of these influences, general contractors are taking on more risk of subcontractor performance at a time when the risk of technical default is greater than ever. To avoid being caught in an exposed position, it is essential that the general contractor be able to evaluate, quantify and mitigate the risk of subcontractor default.

The available risk financing options should also be evaluated. In the economic uncertainty of today’s construction environment, the risks that a general contractor must deal with are of heightened importance.

In this white paper, we cover the following topics:
- How subcontractor risk is managed and insured.
- Alternatives for financing this risk.
- Analytical methods for quantifying subcontractor default risk.

ACTIVE MANAGEMENT OF SUBCONTRACTOR DEFAULT RISK

Contractors are responsible for adhering to completion dates and project specifications. They retain not only the risk of managing their own work but also significant risk for a subcontractor’s failure to perform according to the contractual terms agreed to with the owner.

Because the costs of subcontractor default are significant, a general contractor will often go to great lengths to avoid terminating a subcontractor. This can include renegotiating the contract, reducing the scope of the subcontractor’s work, providing supplemental staffing, assisting with payroll and directly procuring equipment or materials. “Helping the subcontractor across the finish line” reflects the reality that a terminated subcontractor ends up costing all parties involved significant sums of money and significant additional time.

The active management of subcontractor default risk begins with subcontractor prequalification and continues with active monitoring of subcontractor performance and payments. Prequalification should include financial analysis of the subcontractor, reference checks with other general contractors, suppliers and second tier subcontractors, the general contractor’s own past experience with the subcontractor and a thorough review of the subcontractor’s safety performance and quality assurance/quality control procedures.

As a general contractor, the monitoring of subcontractor performance and payment is the responsibility of your home office staff and your field staff. You need to ensure that your staff is appropriately trained to understand the financial impact of paying for work that was either not performed or was performed improperly by a subcontractor. Either event will negatively impact your projected costs of project completion, particularly so if extensive rework is involved. Additionally, consideration should be given to spot-checking the subcontractor’s payments to suppliers and second-tier subs, as the job progresses, to be certain that those parties have been reimbursed appropriately by your subcontractor on your project. Lien waivers from all parties should be required as a condition of payment.

Lockton has developed several tools and services to assist general contractors with the prequalification, selection and payment/lien waiver management of subcontractors. For more information on these services see the sidebar discussing SCORE and PayLock.

ALTERNATIVE APPROACHES TO HANDLE SUBCONTRACTOR DEFAULT RISK

Two decades ago, surety bonds were almost exclusively used to manage the risk of subcontractor default, but this has since evolved. In the 1990s, Zurich developed an alternative to surety bonds called Subguard®, an insurance solution that reflects in many ways the economic reality of the risk. Recognizing that general contractors often incur costs to avoid having to terminate a subcontractor who is in technical default, Zurich designed Subguard® to allow a general contractor to assume some of the risk of a defaulting subcontractor and transfer losses above the Subguard® program retention to Zurich. The product is priced in a manner to allow it to be competitive with the costs of procuring subcontractor payment and performance bonds.

Subguard® is, in fact, a loss-sensitive insurance program where the general contractor, in exchange for assuming some of the risk, stands to potentially receive a portion of the program costs if it is successful in managing the risk of subcontractor default and
minimizing loss payments. The concept is similar to a Contractor-Controlled Insurance Program (CCIP) which typically functions on the same basic premise but is geared toward controlling loss costs arising from general liability claims, workers’ compensation claims or both.

Participating in the risk allows a general contractor to offset costs associated with instances of technical default, but where the general contractor worked with the subcontractor to avoid having to terminate the subcontractor. It should be noted that Subguard® will also respond should any mitigating measures fail and the general contractor is forced to terminate the subcontractor. Subguard® allows a general contractor to share in the upside of managing the risk and yet protects it from the more severe financial consequences of a default. This risk-sharing approach allows general contractors to focus on getting the job completed on time, on budget (subject to their retention under the program) and according to contract terms. The ability to manage situations of technical default, e.g., where work was not performed according to specification, the financial distress of a subcontractor, etc., creates a more effective claim management tool for the general contractor.

Under the Zurich Subguard® program, there are several options available. The amount of subcontractor default risk a general contractor wants to self-insure versus transfer to Zurich is one issue. The amount of insurance limits to purchase is another. There are also various ways the Subguard® program can be structured. It can be set up as a paid loss (self-insured retention) or under a retrospectively rated program. There are various financing and tax issues that come into play under either program scenario.

The important point is to make sure the general contractor is evaluating each option on an after-tax cash flow basis against the contractor’s cost of capital.

It is worth mentioning that in the last two years, both Arch Insurance Group and XL Insurance have entered into the market with Subcontractor Default Insurance (SDI) products, thus expanding the choices available to general contractors.

Beyond surety bonds and Subguard®, captives offer another risk financing method for subcontractor default risk. A captive can enhance the accounting and reserving function associated with subcontractor default. By segregating those exposures and accounting for costs in a transparent manner, a captive can be a tool for project managers to more effectively control technical defaults. This is in contrast to merely embedding the project overruns in other project costs and having the company pay them out of cash flow as if they were not insurable risks.

For contracts, including government contracts, where self-insurance costs are a part of the bidding process, the precision associated with the formal premium and loss reserving process for a captive will allow for a more accurate identification of those costs. Passing on costs to project owners or the government is based on proper accounting, detailing and disclosure of the various cost elements.

A captive can be a way to formally fund for uninsured subcontractor default risk (subcontractors that are not bonded or merely funding for retentions under the Subguard® program). There are several key issues to take into account when reviewing a captive option. A captive is a C-corporation for tax purposes, and funding risks in a captive could lead to double taxation if the general contractor is organized as an S-corporation or LLC. Also, we often determine that is it is more efficient to only place a portion of the subcontractor default risk in the captive to avoid onerous capitalization and funding requirements.

Determining the true cost of self-insurance and accounting for that in a manner that assists the contractor in managing the claim and the costs are of primary importance. Additionally, these factors, along with the long-term nature of the risk, make the use of a captive insurance company an attractive risk financing alternative. A captive can also be used as reinsurance under the Subguard® program.

Most large general contractors employ a variety of solutions for managing the risk of subcontractor default. They may bond some subcontractors, use Subguard® on others and choose to completely self-insure the risk of default for other subcontractors.

AN ANALYTICAL APPROACH FOR QUANTIFYING SUBCONTRACTOR DEFAULT RISK

As mentioned previously, a general contractor’s loss experience for subcontractor default is often in situations of technical default rather than in situations where the subcontractor has been terminated by the general contractor. In these situations the general contractor can be said to have effectively mitigated the default. This does not mean that there were not any costs associated with the default, but rather effective project management dictated a speedy resolution that benefited from not going through the process of terminating the subcontractor. Without quantifying these costs, a general contractor will have a difficult time getting these.

Our process includes review of all costs associated with self-insuring subcontractor default. We work to understand the historical significance of those claims and quantify, based on those historical
results and future economic trends, the forecasted future costs. For this exercise, we review all historical loss cost information as it relates to subcontractor default. In order to build a cost for subcontractor default into projects, we calculate based on an actuarial base the loss experience of the general contractor by looking at all of the costs associated with default.

To demonstrate the output of our model, the following chart provides a comparison of the estimated costs under a Subguard© program, assuming the Subguard© retention is 100 percent of the first $1 million of each claim, followed by a 20 percent quota share of the next $2 million ($1.4 million Per Loss Retention) versus the costs of 100 percent self-insurance.

The chart provides the distribution of the total cost (premium plus retained loss) and the associated probability of those outcomes. The information provides the possible upside opportunity, the probability of winning and the potential downside risk or adverse outcomes.

In this analysis, we assumed $500 million in subcontractor exposures. Based on the loss activity and the simulation, we expect approximately one out of two years to have a subcontractor default in excess of $1 million. Applying the program retentions in this example, the estimated expected retained losses would be approximately $1 million, with an estimated probability the losses would exceed $2 million 40 percent of the time. Assuming a risk transfer rate of $3.79 per $1,000 of revenue, this produces an estimated premium of $1.895 million or a total expected cost (premium plus retained expected losses) of $2.895 million.

For 100 percent self-insurance, the expected losses are approximately $2.8 million, and this option wins approximately 75 percent of the time. However, the maximum estimated cost under the current program is approximately $3.1 million, and 25 percent of the time 100 percent self-insurance produces a significantly higher cost.

In this example, the protection that insurance provides from a significant downside event indicates a slightly lower overall cost than a 100 percent self-insurance option.

In addition to comparing the Zurich Subguard© program or any of the other SDI programs to self-insurance, these analytics can be used to determine the appropriate captive funding should a contractor desire to insure this risk in their captive. Contractors that actively manage subcontractor work will likewise completely self-insure some subcontractor work. Our analytics can be used to better understand the risks contractors are assuming and serve as a foundation to recoup the costs of self-insurance when neither a bond, Subguard© or another SDI product are utilized.

Yet even with proactive processes in place, the risk of default remains. Using analytical models to estimate the likelihood of default helps to manage the bottom line and evaluate risk financing options. Because recent economic conditions have created circumstances that may be a precursor to a rise in subcontractor defaults in 2011 and 2012, now is a good time to quantify risk and evaluate your options. To learn more about our analytical models, contact Mark Morris, Senior Vice President in the Construction Services Group, at mmorris@lockton.com, or phone 816.960.9988 to schedule a consultation.