

PP006 – Subcontractor Default Insurance

Introduction

Subcontractor Default Insurance (SDI) is an indemnity insurance policy that is designed to protect large general contractors from risks associated with subtrade default.

Background

When discussing security with owners, select general contractors have held that their risk is driven primarily by sub trade performance. Given that very little work is usually self-performed, these select general contractors claim that an SDI policy that addresses subtrade failure is sufficient project security and is a viable alternative to performance and labour and material payment bonds.

The logic follows that by forgoing surety bonds, obligees can derive all the protection they need, as well as cost savings through an SDI policy. This is simply not so. An SDI policy responds only in the event of the default of a covered subcontractor and does not provide for any recovery for losses arising from the default of the prime contractor. Obligees should understand that the general contractor can choose not to cover all subtrades on a given project.

Therefore, obligees should be aware that relying on this practice in lieu of the general contractor providing performance and labour and material payment bonds, not only exposes their project to the risks associated with a general contractor default, but also presents a risk to its subtrades and suppliers.

SAC Position

The Surety Association of Canada (SAC) believes that the practice of promoting SDI to obligees as a substitute for prime contractor bonding is misleading and can leave not only the obligee, but also subcontractors and suppliers unprotected in the event of a prime contractor failure.

Obligee Protection

Under the standard policy, the obligee is not a principal to the coverage afforded through SDI, and therefore, the obligee would not be in a position to claim in the event of a general contractor default.

Furthermore, SDI only responds in the event of a subcontractor failure. There are many other factors that can lead to the non-performance of a general contractor, including external factors not relating to the contract. Failure by a general contractor, while subtrades continue to perform, would leave the project exposed.

Subtrades, Suppliers and Other Considerations

Subtrades and suppliers are also left unprotected should an obligee choose to forego surety bonds. An SDI policy does not provide any assurance of payment by the general contractor to subtrades and suppliers. A labour and material payment bond is the only security instrument that provides dedicated payment protection to subcontractors and suppliers of a defaulted contractor. Without the benefit of a labour and material payment bond, protection of trades and suppliers is limited to their pro-rata share of any holdback funds being retained by the obligee. This protection can amount to pennies on the dollar.

Summary

Every obligee needs to determine its own risk tolerance. While SDI can be an effective risk management tool for protecting larger general contractors from subtrade default, it leaves the obligees, subtrades and suppliers exposed should the insured general contractor default.

Performance and labour and material payment bonds are the only way to protect obligees, trades and suppliers in the event the prime contractor defaults.

Glossary of Terms

Obligee

An individual or organization in whose favour an obligation is created and to whom a bond is given.

Principal

The individual or organization that bears the primary responsibility for fulfilling the obligation under the written contract referenced in the bond and that has the duty to perform for the Obligee's benefit.

Surety

The party to a surety bond who answers to the Obligee for the Principal's default or failure to perform as required by the underlying contract, permit or law.

This paper is intended to serve as a general guideline to assist members and other readers in responding to the issues discussed. Nothing contained herein should be construed as legal advice and readers are cautioned to consult with legal counsel for such advice.

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