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Construction Lending

Default Insurance or Performance Bond?

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Construction lenders generally require borrowers on major projects to obtain performance bonds from their contractors. For the past several years, however, an alternative to performance bonds has been available in the form of contractor default insurance, marketed under the name "Subguard" by Zurich North America Insurance Company. This article will discuss the basics of Subguard and compare it with a traditional performance bond.

Subguard Basics

Subguard directly indemnifies the insured for any costs which result from the default in performance of any unbonded contractor or subcontractor.¹ The product is available to owners, but it has been primarily purchased by general contractors who seek to protect themselves against defaulting subcontractors.² The policy involves large deductibles and upper-tier coverage that provides insurance in the event of a catastrophe. The insurance policy and the premiums are written and calculated in the anticipation of losses.³ Pricing is determined based on the general contractor's profile and the amount of subcontracted work, and

is generally less than for a performance bond. Most policies have a per-loss deductible and a limited co-payment provision.

Certainty of Performance

Under a performance bond, a premium is paid to the surety to guarantee that the construction contract will be performed in

Under Subguard, the insured is only entitled to damages in the form of monetary compensation (i. e., insurance proceeds) when a default occurs. The amount of damages available to the insured is contingent upon the limit of liability specified in the policy and, as noted above, is subject to deductibles and co-payments proportional to the limit of liability. Additionally, the insured may be required to advance funds to replacement contractors while it awaits insurance proceeds. Thus, Subguard, unlike a performance bond, does not necessarily insure project completion. Of course, under a performance bond, the cooperation of the surety is required and, as is often the case, the surety may be unwilling to complete the project, especially where its principal challenges the alleged default.

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the event of a contractor default. In the case of a default, the surety may forfeit the bond's penal sum, finance the principal's completion of the project, tender a new contractor to complete the project, or allow the obligee to proceed at its discretion and at the surety's expense. The obligee may recover from the surety the reasonable cost of completing the work, including payments to subcontractors, material suppliers and labor claimants; rental income lost by delay in completion; attorney's fees incurred in defending suits by lien claimants; the reasonable cost of correcting workmanship or replacing defective materials; lost profits; attorney's fees (if called for by statute or contract); and liquidated damages provided for by the contract.

Delays In Completion

Because of challenges to alleged defaults, under the performance bond scheme the need for the surety to step in and complete the project can cause further delays. In large construction projects there are frequent disagreements over the assignment of blame for problems that have occurred. Once a default is declared the surety must investigate the claim and determine if there has, in fact, been a default by its principals. This process is often lengthy and, even after the surety has determined there has been a default, there is the risk that the surety will not adequately respond.⁴

Subguard functions differently. The insured determines when the contractor

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has defaulted and remedies the default itself, later to be reimbursed for whatever damages it suffers. It is generally believed that the reimbursement payments have been easier to recover than surety payments.⁵

Filing of Claims

To receive payment on a claim under Subguard, the insured must document the defaults by providing a description of the events of the alleged default and attaching relevant subcontractor or purchase order agreements to substantiate that a loss has occurred. Under the policy, payment is made within 30 days. Defenses to the payment of the claim can include misrepresentation by the insured; fraud by the insured; defaults occurring prior to the policy period; material breach of policy warranties by the insured; and failure to cease awarding contracts to a subcontractor or supplier who is in default of performance.

A performance bond covers construction defaults for the time specified by the contract, bond, or until the statute of limitations expires. This time period is frequently longer than the time it takes to complete the actual construction project. Subguard, on the other hand, is purchased for three- to five-year terms and all claims must be made during the term; that is, Subguard is a claims made form of insurance. Thus, if the default or defect occurs during the time of policy coverage, but there is a delay in discovery beyond the term, recovery is precluded. Subguard places a heavier burden on the insured to supervise the construction site carefully and foresee potential defaults or defects not easily apparent at the time of construction.

Contractor Selection

A major difference between Subguard and performance bonds is the level of control over the selection of contractors. Under a performance bond, the surety performs the underwriting and prequalifies

contractors and subcontractors.⁶ The surety, not the insured (owner or contractor), is able to control which contractors and subcontractors are hired by declaring which contractors are "bondable." Under Subguard, the insured is responsible for selecting suitable contractors and subcontractors and the ability to select contractors and subcontractors can make Subguard a preferred means of insuring a construction project.

Deciding which product to use requires careful consideration of several relevant elements.

Market Implementation

Subguard has been advertised as a means of enabling unbondable minority and disadvantaged contractors to participate in projects on which performance bonds were required.⁷ One contractor has expressed the view that Subguard (among other things) has allowed it to increase minority-owned business representation in construction projects due to decreased costs associated with Subguard. Zurich itself advertises that it is easier for disadvantaged and small businesses to qualify for Subguard than for performance bonds.⁸ These benefits have expanded the number of subcontractors who can compete in the construction market.

Subguard Projects

While Subguard can be less expensive than a surety bond, it is subject to substantial deductibles. This makes Subguard more suitable for large construction projects. Zurich advertises the product as being "designed to address the needs of large general contractors, construction managers and design-build firms with annual subcontractor/supplier expenditures of \$50 million or more."⁹ If a project occurs without a default, the general

contractor or owner can save close to 50 percent of the cost of a surety bond. Thus, the high cost of deductibles can be balanced by careful selection of subcontractors with proven trade records.¹⁰

It must also be noted that Subguard cannot be used for federally funded projects, because the Miller Act of 1935 requires that all such projects be bonded. There also exist many state and local ordinances that mandate bonding for construction projects. In these cases Subguard cannot substitute for performance bonds.

Conclusion

Subguard can be a worthwhile alternative to performance bonds through cost savings and the elimination of delays associated with performance bonds. The typical Subguard user is one who is insuring a large construction project and is willing to carefully prequalify subcontractors. However, while Subguard can be less expensive than performance bonds, it does not ensure the completion of a project and may result in unreimbursed costs. Deciding which product to use requires the consideration of all elements discussed in this article.

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1. Such costs include completion costs created by defaulting contractors, correction costs for defective and/or non-conforming work product, legal costs resulting from default, investigation and adjustment costs, indirect default costs including extended overhead, job acceleration and liquidated damages proximately flowing from the default (subject to limitation).

Zurich In North America, at <http://www.zurichna.com/zus/zsource.nsf/display:openform&id=98> (last modified 2005).

2. Lowell J. Noteboom, "Subguard Subcontractor Insurance—What Is It? Is It an Appropriate Alternative to Surety Bonds?", Construction Law Update (March 2002), at <http://www.legalist.com/mnlawyers/support/noteboomarticle.pdf>.

3. Id.

4. See note 2, supra.

5. Id.

6. Id.

7. Minority Businesses, Global Risk Managers, Inc., at <http://www.globalriskmanagers.com/minority.html> (last modified 2003).

8. See note 1, supra.

9. Id.

10. See note 2, supra.