

## Default insurance and Surety bonds: The difference and how they operate

Mohammad Akhtar Beg

Project Manager, Towel Construction & Co LLC, Muscat, Sultanate of Oman

### Abstract

A construction project will almost always involve a number of agencies like subcontractors and suppliers whose performance will directly impact on the performance of the total project in relation to the accomplishment of a successful project completion. Owners and contractors are always at a risk of non-performance of these agencies, which may sometimes lead to catastrophic results for the owner or the main contractor. Surety bonds have been a traditional way of mitigating such risks, however recently a new product Default Insurance has been launched by Insurance companies which claims to serve the purpose of mitigating risks of non-performance of these agencies. The Paper analyses and compares between a surety bond and the insurance policy.

**Keywords:** default insurance, surety bonds, subcontractor nonperformance

### 1. Introduction

Construction projects are often complex and high risk endeavors. Complexity is inherent in a construction project. Construction can be said to be a manufacturing process minus the controlled and predictable environment of a factory. These are manufacturing processes which are prone to a number of high risk elements and to add to this there lies a challenge of completion on time, and to achieve this a major emphasis lies in doing things right in the first time. The coordination of the sheer number of agencies involved in a major construction project is a major challenge to deal with. First the designs have to be finalized by the architects and the designers and then during the construction process a number of agencies have to be coordinated to make the project a success.

A major concern of the main contractors on any construction project is the adequacy of the performance of its subcontractors. Although there are always contractual<sup>1</sup>, legal<sup>2</sup>, statutory remedies to mitigate the risk of contractual nonperformance of subcontractors and contractors, but these remedies may or may not have actual value, like in cases where the subcontractor becomes insolvent, it would be difficult for the main contractor to recover anything for the default of the subcontractor.<sup>3</sup> For more than a hundred years now payment and performance bonds have been the acceptable means of protection for contractor and subcontractor defaults on a construction project. Usually it is mandated by a statute to provide such bonds for public work projects in many countries.<sup>4</sup> Also for private works owners and contractors rely on such bonds for protection against the risk of non-Performance of their contractors.

However a new type of risk management solution has been launched recently to manage such risks, a product known as Default Insurance was developed in partnership of insurance providers and construction firms to address problems that the firms believed were not being covered optimally through the existing mechanisms of risk management. "SubGaurd" is a

product launched by Zurich N.A. Insurance Company in 1995, other insurance providers have also launched similar products on the same line as Zurich Subgaurd, but SubGaurd is the leading carrier. This relatively new type of insurance product was launched to offer risk cover to: cost of completing the works; cost of investigation and correction of defects; legal and professional fees; liquidated damages; overhead costs.

The product is available in one of the two categories; the "subcontractor default insurance" which is obtained by a general contractor directly from an insurer to insure the performance of its subcontractors in place of the performance material and labor bonds, while the "contractor's default insurance" is purchased by the owner or the employer to replace the surety bonds which he would normally require from its contractors, although not advisable in case of owners due to the absence of a prequalification mechanism which is a necessary factor of default insurance and is discussed below in detail.

Both the products; performance bonds and default insurance, are seemingly different but provide the same purposes; among other things to mitigate the risks of performance of a contractor or a subcontractor. The criteria of selection of any of these products in the view of a contractor or an owner will depend upon the following points which are discussed in detail below:

### 2. The contractual and underwriting matters

Bonds, guarantees, and Contractor Subcontractor default insurance each have their own peculiar, legal implications, which risk purchasers should consider in the context of their risk tolerances and project requirements. A surety bond or a guarantee is a contract among three parties, the principal, the obligee, and the surety. The surety's promise to the obligee is not one of indemnity, but instead is a promise to provide substituted performance or to pay money, limited in amount to the penal sum of the bond, in the event of the failure of the

<sup>1</sup> Construction contracts usually provide for detailed provision of damages, including liquidated damages for delay, dispute resolution clauses.

<sup>2</sup> In addition to breach of contract, common law remedies like quantum meruit may be available to the aggrieved party.

<sup>3</sup> See *Zigguart (Claremont Place) LLP v HCC International Insurance Co Plc* [2017] EWHC 3286 (TCC).

<sup>4</sup> Usually for Projects controlled by the State a requirement of a performance bond is mandatory.

principal to perform. The premium paid for the bond is not calculated based on the possibility of the occurrence of an event instead it is based on a financial credit from the surety to the principal. A Surety providing the performance bond routinely assess risks, and the surety underwriting process is more rigorous than a traditional insurance underwriting and before issuing a bond the surety analyzes not only the contractor's financial capacity but also its construction capabilities and project experience.<sup>5</sup> A feature which however distinguishes surety bonds from insurance is the principal owes a duty of indemnity to the surety to indemnify and hold harmless the surety from any loss or liability that a surety may incur as a result of the execution of the bond. This duty was created at common law, but sureties do not rely on the common law for the indemnity and may require its principal and often third parties such as the corporate management to sign the indemnity agreement. Thus the prequalification of a subcontractor for issuance of a surety bond is strict and the subcontractor will have to provide all confidential information regarding its finances and business plans to the surety underwriters who will issue a bond only after a strict underwriting process which will involve the assessment of the subcontractor on its various financial and commercial background and a surety company may issue a bond only when it is satisfied that the subcontractor or contractor will be able to fulfill its obligation. So when bonds are a requirement of a project subcontractors will be bidding among other qualified subcontractors and this requirement will automatically filter out contractors who according to surety underwriters are not fit to fulfill this obligation. Further the long history of use of surety bonds, has created precedents and the legal language has been well settled. A bond may be contained in just a page or two but can be interpreted and settled as a result of its long history of use and accepted legal precedents.

Default insurance on the other hand is focused largely on the owner or the general contractor, rather than the subcontractor, and relies on it to select the subcontractors. Thus there is one fewer entity screening the subcontractor which increases the risk of the default. It is however argued that default insurance is not for those contractors who cannot or are unwilling to manage their subcontractors, and coverage should not be offered in such circumstances, as contractors who are able to qualify their subcontractors will impart a greater control over their subcontractors and the project. The underwriting considerations of a default insurance is the financial stability and profitability of the contractor or owner as well as its experience of the contractual business and its history of subcontractor default claims. Default insurance focusses on the contractor rather than the subcontractor in its underwriting process and consequently it relies on the contractor to select and prequalify its subcontractors and manage them through to the completion of their scopes. Losses paid by the insurance can be recovered by subrogation from the defaulting contractor, and the contractor is under an obligation to support the subrogation process.

### 3. Payment of claims in case of a default

In case of a default, surety has the flexibility to finance the completion of the scope of works defaulted, tender a new

subcontractor or take over the works itself. In public projects this may be an important criteria for the contractor or the owner, however contrary to the belief of some owners or contractors, default by the principal will not entitle the obligee for the full value of the bond. The obligee is entitled to the amount of actual damages, thus the surety will need to investigate the claims from the perspective of both the obligee and the principal, and to confirm whether the obligee has performed his obligations or not. This may lead to a slow response from the surety which may be disastrous to the performance of the contract with strict time durations. However to solve this problem the subcontractor can be asked to submit an on demand bond instead of a guarantee, so as in case of default the contractor can call upon the surety to pay the bond.<sup>6</sup> Thus the beneficiary of such type of a bond is protected from proving its losses and delays in settlement of claims. In contrast to the claim process of performance bonds, in default insurance once the qualifying loss is calculated the insurer makes a payment to the insured within thirty days after it accepts a satisfactory proof of loss. There is a provision for payment of an advanced percentage of loss in cases where the loss has not yet been finally determined, such provisions in default insurance minimize cash flow concerns of the insured. However default insurance does not allow the insurer to complete the works or to obtain another contractor. The contractor has to get the works completed, pay for the works first and then seek indemnity from the insurer for the qualifying losses. Hence with a default insurance a contractor may stand to lose a considerable sum before the policy kicks in, whereas in case of surety bonds the obligee "gets paid for each dollar". However default insurance can be a fast and more reliable alternative to surety bonds in covering impacts of a catastrophic default.

### 4. Commercial viability and coverage

The cost of a performance bond may be at par with a default insurance however the cost of a performance bond is for a single project and will never be reduced if nothing goes wrong or there are no claims, it is "money out of the door"<sup>7</sup>, in contrast the maximum price of a default insurance will be comparable to a surety bond and there will be an adjustments and considerations for the frequency of claims thus making a default insurance policy more commercially viable. However, default insurance policies also require a substantial deductible making it cost effective only on very large projects and for contractors who already have an effective subcontractor prequalification and management process. The insurance policy offers vast coverage, even of small subcontractors who generally would not qualify for a surety bond, whereas a surety bond will not cover small contractors and will issue bonds to individual contractors focusing only on a single aspect of a multiple faceted construction isolating other contractors, while default insurance focusses on the whole aspect of the construction process and offers coverage to the performance of all subcontractors which is more beneficial and practical when it comes to dealing with issues of nonperformance. Default insurance affords more flexibility and control to the contractor in dealing with situation of default holistically. The ability to retain control may be worth the cost as it imparts more control to handle

<sup>5</sup> Edward G Gallagher, *Introduction to the Law of Suretyship* (2edn 2002)

<sup>6</sup> *Enka Insaat Ve Sanayi As v Banca Popolare Dell'alto Adige Spa* [2009] EWHC 2410 (Comm)

<sup>7</sup> Terry Gray, *Point/Counterpoint: Default Insurance- An alternative to Traditional Surety Bonds*, (2002) *Constr Law*, 17,21

situations of default in projects with tight time lines. However until the main contractor places the subcontractor in default there will be no coverage for the main contractor. A Default insurance policy is not a builder's risk policy and will not cover issues of out-of-specification material, instead it covers the losses related to the non-performance of the subcontractor which are within the contract.

## 5. Conclusion

Cost increases and poor response by sureties have caused contractors to look around for other options, to manage the risks of nonperformance of subcontractors and one of the products which they will be following with interest will be the performance of default insurance in such situations. Performance and surety bonds have a history of its performance and has withstood its position amidst changing economic scenarios. Whereas despite the various attractive and practical solutions provided by default insurance, it will have to be seen how it continues to fair in future with forecasts of increase of subcontractor defaults.

## 6. References

1. Supply of Goods and Services Act 1982, UK.
2. Insurance Act 2015, UK.
3. Ziguart (*Claremont Place*) LLP v HCC International Insurance Co Plc [2017] EWHC 3286 (TCC).
4. Enka Insaat Ve Sanayi As v Banca Popolare Dell'alto Adige Spa [2009] EWHC 2410 (Comm)
5. Chern C. *The Law of Construction Disputes*. (1st Routledge 2010).
6. Dennys C. *Hudson on Engineering Contracts*. (13<sup>th</sup> edn Sweet & Maxwell 2017).
7. Gallagher EG. *Introduction to the Law of Suretyship*. (2edn, 2002).
8. DJ B. How to Gaurantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Gaurantees and standby Letters of Credit. [2005] Int'L L 51, 37.
9. Helmut K. Contractor/SubContractor Default Insurance. *J Can C Const Law*, [2012] 115.
10. Gray T. Point/Counterpoint: Default Insurance- An Alternative to Traditional Surety Bonds. *Constr Law*, [2002] 22
11. Korman R. Putting to Rest Myths about Subcontractor Default Policies. *ENR*, [2015] 12.
12. Rubin DI. Subcontractor Default Insurance Gains Attention in Tougher Times. *ENR* [2003]14,
13. Schubert LJ. Point/Counter Point; Surety Bonds The Best Protection against Contractor or Subcontractor Default. *Const Law*, [2002]22.