

## **Subcontractor Default Insurance: What Is It and Do I Need It?**

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Major problems often arise on construction projects because of subcontractor default. Defaults most frequently occur when a subcontractor fails to complete its scope of work midway through a project. Historically, the risk of subcontractor default was mitigated by obtaining surety bonds or retention. Now, when an association contracts with a general contractor, it may be asked whether it wants the general contractor to obtain Subcontractor Default Insurance ("SDI"). SDI is essentially an alternative to performance and payment surety bonds which protect against the risk of subcontractor default. SDI is best suited for large projects with large subcontracts.

Typically, when a contractor provides surety bonds, an association has the peace of mind that a third party is 100% liable to ensure completion of the project and payment to subcontractors in the event of a default. SDI, on the other hand, puts that requirement on the general contractor who is reimbursed by the insurer for the costs incurred to cure the default. The insurance company becomes obligated to reimburse costs incurred because of subcontractor default. This differs from a traditional performance bond, for example, where the insurer actually steps in to complete the defaulting subcontractor's work, many times causing extra delay and disruption to the project.

One benefit of SDI is that premiums are usually less than performance and payment bond premiums, which translate into owner savings. This and the greater flexibility and expediency in responding to subcontractor defaults are two of the advantages over traditional bonds. For example, with a traditional performance bond, where the surety is obligated to step in and complete the work of the defaulting subcontractor, a surety may take its time in investigating the default before taking any corrective action. This may cause significant delay on any given project. With SDI, unlike a performance bond, the surety has no contractual obligation to complete a defaulting subcontractor's work. Instead, after providing timely notice of the default to the SDI insurer, the general contractor can move forward with a solution to the problem, such as hiring a replacement subcontractor or completing the work itself, which may substantially mitigate any further delay or disruption to the project. The SDI insurer will then reimburse the general contractor for the costs incurred in remedying the subcontractor's default.

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There is another important difference between SDI and traditional surety bonds. Under SDI, the insurer has no direct payment obligation to a subcontractor's supplier or a sub-subcontractor. Instead, this is a risk the general contractor takes on, in exchange for the cost reimbursement provided under the SDI policy. This is similar to the risk the general contractor assumes in curing subcontractor default, subject to reimbursement by the SDI insurer.

SDI policies also usually carry large deductibles and overall loss limits. Co-payments by the insured general contractor are sometimes required. Overall, SDI seems to offer more control to the association or general contractor, but also puts more of a financial burden on the general contractor who must front the costs to cure a subcontractor default. If an association allows a general contractor to obtain an SDI policy, the contract between the association and general contractor should include a provision obligating the general contractor to absorb all unreimbursed costs. Before agreeing to SDI in lieu of performance and payment bonds, the association should also perform due diligence to ensure the general contractor is financially stable and capable of managing the additional obligations imposed by SDI.