Subcontractor and Vendor Default

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Why Worry About The Risk Of Subcontractor Default?

- Background
  - Recession over
  - Substantial upturn in construction
  - Subs overbooked, undercapitalized and/or undermanned, greater risk of default
  - Contractors’ project management teams frequently do not fully understand subcontractor default risks or impacts
Misconceptions Regarding Subcontractor Default

- Contractors’ project teams may believe
  - The subcontract adequately protects us
  - We should not have to do “their job” for them
  - The sub’s bonding company will either pay or take over if the sub defaults
  - Our lawyers can deal with it
Understanding the Risks of Subcontractor Default

- Contractors’ project teams need to understand
  - Contractual protections have practical limitations
    - Time and money are required to pursue contractual remedies
      - Must follow contractual notice provisions
      - Contract may also allow a cure period
    - If the well is dry…
      - Many judgments are never fully collected
Understanding the Risks of Subcontractor Default

- Contractors’ project teams should understand
  - Bonded subs don’t necessarily mean a quick solution to default
    - Bonding company owes duties to both its principal on the bond and the obligee on the bond.
    - Unless principal (sub) admits default, surety may let it go to litigation or arbitration
  - Defaults = increased cost of completion
    - Zurich study → 1.7 x Orig. Sub Cost
Understanding the Risks of Subcontractor Default

- Increased costs from default terminations are due to
  - Inaccurate Schedule of Values
  - Overbilling for work in place
  - Defective work and increased scrutiny of work = rejected work
  - Rejected work = $$$$$
Understanding the Risks of Subcontractor Default

- Increased costs from default terminations are due to
  - Inspection costs
  - Demolition costs
  - Defining scope for replacement sub for competitive bids
  - Using T&M agreements to speed up remedial work
  - Difficult for GC to be made whole given the additional time-related costs
Understanding the Risks of Subcontractor Default

- Contractors’ project teams should understand
  - Defaults likely impact schedule
  - Schedule delays may cause
    - Additional direct (field) overhead
    - Additional home office overhead
    - Acceleration costs
    - Assessment of Liquidated Damages
    - Liability for actual delay damages
Understanding the Risks of Subcontractor Default

- Contractors’ project teams need to understand
  - Other default repercussions include
    - Lower tier sub & supplier lien and bond claims
    - Spending time to obtain replacement subcontractor & close out of defaulting sub’s contract
Understanding the Risks of Subcontractor Default

- Other default repercussions include (continued)
  - Additional legal and consultant costs
  - Replacement subcontractor issues
    - Latent defective work
    - Warranty
Understanding the Risks of Subcontractor Default

- Default repercussions may include dealing with bankruptcy court
  - Automatic stay as of bankruptcy petition filing
  - Contract provision allowing termination is not enforceable in bankruptcy without bankruptcy court permission
  - Pre-petition termination must be fully completed to be effective
Understanding the Risks of Subcontractor Default

- Dealing with bankruptcy court (continued)
  - Executory contract is “property” of the debtor and thus part of the “bankruptcy estate”
  - Acts in violation of stay are void or voidable
Understanding the Risks of Subcontractor Default

- Dealing with bankruptcy court (continued)
  - Willful violations of the stay are punishable by contempt of court
  - Trustee/DIP may assume or reject executory contracts (time limits are unacceptable)
Understanding the Risks of Subcontractor Default

- Dealing with bankruptcy court (continued)
  - Prime/GC may pursue a Motion to Compel Rejection of the Executory Contract or Motion for Relief from the Automatic Stay
  - Can’t terminate bankrupt sub/vendor without rejection of the contract or relief from the automatic stay to move forward with replacement subcontractor
Understanding the Risks of Subcontractor Default

- Dealing with bankruptcy court (continued)
  - Trustee/DIP may assume the subcontract only if:
    - Default is cured or the Trustee/DIP provides adequate assurance that it will be promptly cured
    - Trustee/DIP compensates a party for any actual pecuniary loss resulting from the default
Understanding the Risks of Subcontractor Default

- Dealing with bankruptcy court (continued)
  - Trustee provides adequate assurance of future performance
  - Court must approve assumption of subcontract
Risk Signs of Subcontractor Default

- Default Risk Sign 1: THE SIGNIFICANTLY LOW BID
  - Request reassurance in writing
  - Ask for estimate (redacted if needed)
  - Thoroughly prequalify
  - Evaluate the risk and possible risk transfer or risk sharing approaches
Risk Signs of Subcontractor Default

- Other risk signs
  - Loss of key personnel
    - Good projects require good people (capable & experienced)
  - Venturing into new types of work
    - Adequate experience?
  - Venturing into new geographic areas
    - Availability of qualified employees?
    - Adequate home office oversight?
Risk Signs of Subcontractor Default

- Another **key early warning sign**: evidence of poor cash flow/financial problems
  - Supplier complaints
  - Lien claims
  - Bond claims
  - Credit/financial ratings going down
Avoidance Strategies - possibly distressed sub - “make or break the job” sub - significant subcontracts – major suppliers

- Require Prequalification (101)
- Consider Risk Transfer & Risk Sharing Approaches (201)
- Maximize Contract Protections (301)
- Utilize Thorough Subcontract Management Program (401)
Default Risk Management 101 - Prequalification Program

- Which Subcontractors Must Be / Should Be / Could Be Prequalified
  - Significant or Large Dollar Subcontractors
  - Specialty Subcontractors
  - Specialty or Hard to Replace “make or break” Subcontractors
  - Subcontractors with “Red Flag” Warning Signs – Overextension, Claims, Very Low Pricing
Default Risk Management 101 - A Prequalification Program

What Should Prequalification Cover?

- Financials, Insurance and Bonding
- Trade and General Contractor References
- Work on Hand / Work History
- Policies, Licenses, Safety, Key Personnel
Default Risk Management 101 - A Prequalification Program

- Prequalification – **Financial, Insurance, Bonding**
  - Gross Revenue/Margin; Audited/Unaudited Financials
  - Credit and Finance Ratings (D&B, Experian)
  - Trade References
  - Ability to Comply with Insurance Requirements
  - Bonding Capacity (total and available)
Default Risk Management 101 - A Prequalification Program

- Prequalification – Experience, Corporate Capability, Work on Hand
  - Client References, Work History
  - Subcontractor Claim History (claims against and asserted)
  - Corporate Structure (owners, parent/affiliate, key personnel, employees)
  - Work on Hand (value, location, current status)
Default Risk Management 101 - A Prequalification Program

- Prequalification – **Safety, Policies, Status**
  - Safety History – OSHA 300 Logs
  - Policies – Safety, Environmental Impact Mitigation
  - MBE/WBE/SBE - Require Certificates for All Jurisdictions
Default Risk Management 201 - Risk Transfer & Risk Sharing

- Primary Forms of Risk Transfer and Risk Sharing
  - Subcontract Performance and Payment Bonds
  - Subcontractor Default Insurance
  - Indemnity Agreements
  - Letters of Credit
Default Risk Management 201 - Risk Transfer & Risk Sharing

- Bonding
  - Bid, payment and performance bonds
  - Bond language controls on private bonds such as a subcontractor bond – “common law” bond
  - Review bond language:
    - Prerequisites to make bond claim – notice to surety, declaration of default?
    - Surety’s obligations – step in and make good or payment?
    - Limitations on liability – penal sum, type of damages, who is claimant?
Default Risk Management 201 - Risk Transfer & Risk Sharing

- **Performance Bond Remedies**
  - Forfeiting the bond’s penal sum
  - Tendering a new subcontractor
  - Financing the defaulted party
  - Allowing the contractor to proceed at its own discretion (and at the bonding company’s expense)

- **Payment Bond Remedies**
  - Payment to Claimants – note definitions!
  - Interplay with Prime Contractor P&P Bond
Subcontractor Surety’s Defenses

- On default, surety permitted to investigate (possibly lengthy investigation – challenges on time sensitive project)

- All defenses available to its “principal” (the bonded subcontractor) – breach by prime contractor, improper declaration of default

Surety’s separate defenses

- Failure to comply with bond’s requirements
- Overpayment / Underpayment
- Material increase in the surety’s risk due to prime contractor’s improper actions or inactions
Default Risk Management 201 - Risk Transfer & Risk Sharing

- Bond claim time frame
  - Give notice, declare default, make demand on surety
  - Surety’s independent investigation
  - Negotiations
  - Legal action
  - Can easily reach two years or more of costs before any recovery on the subcontractor’s bond
  - Common Law Bond Statute of Limitations
Default Risk Management 201 - Risk Transfer & Risk Sharing

- **Bond Verification**
  - Multiple resources available
  - Check surety’s financial rating
    - AM Best; Demotech; Fitch; Moody’s; S&P
  - Beware of financially unstable sureties (risk of liquidation)
  - Check Treasury Dept. approval – State Insurance Regulator
  - Consult your own surety/insurance representative
“Individual” or “Personal” Sureties

- Appears legitimate (FAR)
- Requires a security interest in acceptable assets that equal or exceed penal sum of bonds
- Hard to accurately value the assets
- Subject to fraud or misrepresentation
Subcontractor Default Insurance

- “Niche product” historically Zurich’s Subguard; new market players including Ace & XL
- Policy specifies that the insurance company will compensate the contractor for losses resulting from a subcontractor’s default.
- Most SDI policies cover all subcontractors (generally first and second-tier subcontractors), with GC determining prequalification
- May provide coverage for losses that are the indirect result of a default, such as LDs, acceleration, extended overhead.
- SDI pricing is negotiable – ranging from 0.4 to 0.85 percent of total subcontract values
Subcontractor Default Insurance

**Potential Advantages**
- Lower premium costs
- Control over the prequalification of subcontractors
- No investigation period by a surety after a subcontractor defaults
- May provide coverage of entities otherwise unqualified for a bond

**Potential Disadvantages**
- High deductibles (~$500K)
- Stringent prequalification programs
- Limited feasibility
- Generally medium to large contractors with $75M or more in annual subcontracts
- May not substitute for P&P bonds on public projects
Personal Indemnity Agreements

- Similar to what sureties require from indemnitors
- Obtain from primary shareholders of the sub and their spouses as well
- Psychological value of personal indemnity gives that project priority
- Little actual value if shareholders have no positive net worth

Letters of Credit
Default Risk Management 301 - The Well Written Contract

- **Protective Contract Provisions**
  - Well-defined default, notice & termination provisions
  - Require proof of payments to lower-tier subs/supplier
  - Require lower-tier payment claims be promptly resolved or removed by bond if necessary
  - Right to supplement work
Default Risk Management 301 - The Well Written Contract

- Protective Provisions
  - Right to joint check agreements
  - Right to make direct payments to unpaid sub-sub/suppliers
  - Provide for setoff rights
  - Termination for convenience
Default Risk Management 301 - The Well Written Contract

- Protective Provisions (continued)
  - Forum selection and dispute resolution of your choice
  - Conversion to termination for convenience in event of wrongful termination for default
  - Schedule of Values (“SOV”) verification and right to revision if warranted
  - Right to periodic financial statements upon request
  - Pass thru provisions
Default Risk Management 401 - Thorough Subcontract Management

- **Goal #1: Accurate SOV**
  - Require documentation
  - Revise as needed

- **Goal #2: Maintain Schedule**
  - Track closely
  - Supplement if necessary (provide notice)
Default Risk Management 401 - Thorough Subcontract Management

- **Goal #3: Prevent overbilling**
  - Verify work quantities and confirm work is properly performed
    - All required submittals provided, submittals comply with contract & were approved (field v. home office)
    - Work in place complies with approved submittals
    - Verify quantities of work in place and stored materials with each billing cycle
Goal #4: No lien or payment bond claims

- Require list of sub-sub and all suppliers and update/confirmation with each payment application
- Require proof that lower tier subs/suppliers are paid (lien waivers, conditional/unconditional release, written confirmation from subcontractor principal, confirmation with suppliers monthly)
- Use joint checks or direct payments if needed
- Require prompt resolution or removal of claims
Goal #5: Good documentation

- Written record of facts, not feelings
- Photos of work in place
- Communicate like professionals
  - Email Risks
    - Lack of proofing/editing
    - Inappropriate jokes/photos
    - Venting
Manage Risk of Subcontractor Default

- Develop Prequalification Program
- Consider Risk Transfer & Risk Sharing Approaches
- Maximize Contract Protections
- Utilize Thorough and Consistent Subcontract Management
Questions?

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