

# Subguard versus surety bonding

by Robert M. Overbey Jr.

It is becoming more commonplace for large general contractors to consider implementing an insurance product known as Subguard in lieu of requiring the more traditionally accepted performance/payment bonds from its subcontractors. (For example, the Arizona Cardinals new stadium in Arizona utilized Subguard rather than subcontract performance/payment bonds).

Subguard, which was developed by Zurich North American Insurance Company in 1995, is a 2-party agreement that shifts the burden of defaulting subcontractors to the insurance company, as the policy specifies that the insurance company will compensate the contractor (GC) for losses resulting from a subcontractor's default. Further, rather than issuing individual policies for each sub, this subguard policy covers all subcontractors on a given project or on an annualized basis for all projects combined. The policy generally covers both first and second tier subcontractors. Subguard also provides coverage for indirect losses due to subcontractor default, including liquidated damages, contingencies, etc. Lastly, the pricing is negotiable, usually averaging from 0.4% to 1.00% of the total subcontract values.

Subguard targets private projects as opposed to publicly bid projects.

Surety companies consider Subguard as a potential risk because there may be no extensive checks on these subcontractors insofar as their qualifications and financial strength is concerned. Moreover, there is no protection, according to sureties, under Subguard for payment to subcontractors or suppliers, which would be provided by a payment bond.

Subguard can provide a reasonable alternative to performance/payment bonds for large general contractors who have the resources to investigate subcontractors and suppliers. And the contractors will potentially benefit from the lower costs of this default insurance. Conversely, smaller general contractors may be better protected by the 3-party surety relationship, i.e. Principal (contractor), Obligee (Owner or GC) and Surety company when addressing the risk of subcontractor default. A bonding company's prequalification of a contractor/subcontractor can be a valuable loss-prevention measure for many companies.

## PREQUALIFICATION

- Subguard – Insured (general contractor) maintains the responsibility for gathering financial data and other pertinent underwriting information on applicable subcontractors to determine whether or not the subcontractor will be pre-qualified and thus accepted under the Subguard program.
- Surety Bonds – Surety provides the underwriting and pre-qualification.

## COVERAGE CANCELLATION/VOIDED COVERAGE

- Subguard – Coverage may be voided or cancelled if certain underwriting procedures are not followed or if incorrect information is provided and/or determined.
- Surety Bonds – Once the bond is executed, it remains in force and may not be cancelled (even for non-payment of premium).

## CLAIM RESOLUTION

- Subguard – Default Insurance makes the general contractor responsible for resolving subcontractor default issues, although the costs of completing the work are covered.
- Surety Bonds – If a subcontractor that has bonded its work to the general contractor defaults, surety companies help resolve the claim, deal with unpaid creditors and assure that the work under contract is completed.

## POLICY TERM

- Subguard – The insured/general contractor commits to a 3 to 5 year policy term generally, but it may be extended to 10 years.
- Surety bonds – There is no time frame for cancellation or non-renewal of a contract bond, but the bond generally expires as soon as the maintenance/warranty period is reached.

## AGGREGATE LIMIT OF LIABILITY

- Subguard – The insured/general contractor must pick a limit of liability and hope that this is sufficient, e.g. the total dollar amount of the subcontracts for job-specific or for all projects on an annualized basis.
- Surety bonds – Owner and/or general contractor may elect to have performance and payment bonds each equal 100% of the contract amount.

#### Payment bonds.

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The comparison is as follows:

#### DEDUCTIBLES

- Subguard – Deductibles (sometimes quite large) are required before coverage is activated and provided.
- Surety bonds – No deductibles apply; protection is first dollar.

#### COVERAGE PAYMENT

- Subguard – Insured (General Contractor) pays the contractor or subcontractor default and then turns in a claim to collect from Subguard.
- Surety bonds – Surety pays the loss to the obligee or to its own principal/contractor and then the principal must respond as per the indemnity agreement, but the surety is responsible for paying the bills.

#### DEFAULT

- Subguard – Insured takes over project and manages the defaulting contractor's obligations under the construction contract.
- Surety bonds – Surety may be called upon to either take over the project, rebid the job to another contractor, provide the principal (contractor) with the funds necessary to complete the project, or pay the obligee the penalty under both the performance and payment bonds, whichever applies.

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#### CLAIMS

- Subguard – These policies are generally written on a claims-made policy, which means that claims must be made during the policy, so defective workmanship discovered after the policy expires or is cancelled would not be covered, unless arrangements with the underwriter are made to provide a retroactive period and/or a policy tail.
- Surety bonds – The bond continues to provide protection against legitimate performance and/or payment claims until such time for filing a suit – as stipulated in the terms of the contract agreement – or statute of limitations has expired. Note – Subguard does not necessarily guarantee that the project will be completed.

There are certainly pros and cons related to a general contractor's decision with respect to Subguard vs. standard surety bonds. However, it is arguable that traditional surety bonds provide more protection to the project's owners, subcontractors and/or suppliers and have withstood the test of time in relation to overall contract protection.

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