



SURETY PRACTICE

## Managing the Risk of Subcontractor Defaults

A struggling subcontractor can have far-reaching financial and performance consequences on a construction project. In a worst-case scenario, a subcontractor default could result in project delays, jeopardize profit margins, and damage relationships between contracting parties.

It's essential that general contractors, construction managers, owners, and lenders take steps to mitigate the risk of subcontractor default, including reviewing subcontractor qualifications prior to any awards and considering the purchase of insurance. Marsh can help these companies assess their risk, analyze their subcontractors' financial health and stability, and build robust insurance programs that can respond as intended in the event of a default.

### Subcontractor Default Insurance

A significant risk for any construction firm is the possibility that a subcontractor will default on its obligations. Historically, surety bonds have enabled contractors to transfer the risk of subcontractor failure. But they are not the only solution available to contractors.

Subcontractor default insurance (SDI) can offer an alternative approach. SDI is a first-party insurance policy that indemnifies a contractor for costs incurred as a result of a default in performance of one of its subcontractors. A policy can cover costs that are directly related to a default as well as indirect costs that a contractor may incur.

SDI coverage can be written on a portfolio basis or for a specific project, making a fixed-dollar limit available to pay claims. The insured contractor is responsible for prequalification of subcontractors and for undertaking all actions to resolve or settle any loss. SDI policies can offer:

- Broader coverage than subcontractor bonding, including coverage for indirect costs.

### WHO IT'S FOR

General contractors, construction managers, owners, and lenders facing the risk of subcontractor default.

### WHAT YOU GET

- A first-party insurance policy to respond to a default of contract by a subcontractor.
- Better control of subcontractor selection and prequalification.
- A benchmarking report that scores a subcontractor's financial factors for potential default.
- Access to a variety of additional risk control services from Marsh.

- The ability for insured contractors to control the claim process in the event of a performance default.
- A potentially more cost-effective option than subcontractor bonding.
- Contractors that purchase SDI coverage can benefit from a potential reduction in losses, which can help them keep projects on schedule and within budgets. SDI programs often offer more favorable pricing than surety bonds as their subcontractor prequalification processes are improved.

## Financial Credit Analysis Through SubSecure

SDI coverage can provide a critical backstop in the event of a default, but it's not the only way construction companies can manage their risk. Avoiding the risk of subcontractor default requires a thorough review of subcontractor qualifications prior to subcontract awards. Through SubSecure, Marsh's Construction Practice can help construction companies analyze their subcontractors' financial situation and provide guidance for managing the risk that they may default.

SubSecure measures various financial factors to identify subcontractors that present a high risk of defaulting. SubSecure can evaluate subcontractor' financial reports against standard financial reporting guidelines, including:

- Reviewing opinion letters, financial statements, supplementary information, job schedules, and footnotes to financial statements.
- Scoring a subcontractor's balance sheet, work in progress, income statement, cash flow, working capital, and net worth by comparing them to ratios commonly used by sureties in their underwriting reviews.
- Reviewing subcontractor credit reports to identify any liens, judgments, or lawsuits outstanding.

From this, SubSecure can generate a Z score for each analyzed subcontractor, which represents a measure of a subcontractor's corporate financial distress and potential for bankruptcy. The Marsh Construction Practice can provide construction companies with regular reports detailing the quality of their subcontractor portfolios, which can inform decisions about choice of subcontractors and whether to bond them or apply tighter financial and operational controls.

## The Marsh Advantage

Managing subcontractor default risk is critical to the success of any construction company. Marsh can offer you access to a highly experienced, global network of SDI and surety consultants who can help you mitigate, manage, and reduce your total cost of risk through a combination of consultative advice, insurance program design and placement services, and claims preparation and advocacy.

Beyond helping you build a robust SDI program and using SubSecure to benchmark your subcontractor default risk, we can also offer a variety of consulting and loss control services, including:

- Construction consulting services, including project governance, performance audits, dispute resolution, and expert testimony.
- Fraud monitoring and forensic investigation support.
- Workforce strategies and safety solutions.
- Claims advocacy and reviews from specialists at Marsh Risk Consulting.

For more information, visit [Marsh.com](https://www.marsh.com), contact your local Marsh representative, or email us at [suretypractice@marsh.com](mailto:suretypractice@marsh.com).

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