Managing Subcontractor Risk in 2012
Managing Subcontractor Risk

Our last edition of *Managing Subcontractor Risk in 2010* was authored during a time when there were fewer subcontractor defaults than anticipated by either the Surety or Subguard markets. As margins were eroding, competition was increasing and backlogs were dropping. The industry as a whole quickly reduced overhead and expenses in anticipation of a sharp decline in work.

Since then, two trends have emerged that emphasize the uncertainty present in the market. The first is where subcontractors voluntarily close their doors after completing all open projects. The basis for this trend is the perception that it is extremely difficult to maintain a profitable business during this stage of the market. Other factors include the lack of succession planning as well as the ability/willingness to explore new industry segments or territories. Some of these businesses are over half a century old and are making the conscious decision to quietly exit in an orderly manner since the market will not allow them to sustain their operations.

Although the first trend serves to mitigate losses in the Surety and Subguard markets, it is a prelude to the second trend – the remainder of the subcontractor community fighting for survival. For those subcontractors who have not left the market, depleted backlogs, severely reduced overhead and expenses, and fluctuations in material costs are some of the reasons losses are now increasing steadily within the Subguard environment (see Exhibit #1). Many subcontractors do not have the cash or credit lines needed to sustain an uninsured loss. Additionally, some owners have pushed payment terms to unprecedented lengths. With more subcontractors fighting for less work, many businesses are pursuing jobs that are either larger than they are accustomed to or smaller than they would prefer. Much like a new entrant in an unfamiliar territory or market segment, taking on work that is outside a subcontractor’s comfort zone can lead to unexpected costs and challenges that are not adequately covered by project margins.

Thankfully, the overall construction industry appears to be rebounding. Tim Sznewajs, Managing Director at FMI Capital Advisors, Inc., states, “The total non-residential buildings sector is projected to grow at 4% in 2012 from 2011 levels. While this is solid growth, it is off of a relatively low base amount from the prior year. For some perspective, total put in place construction in the non-residential building segment for 2012 will be $341B, down from a peak of nearly $500B in 2008. This increase will be uneven throughout the country with certain markets continuing to experience a decline.”

Within the Subguard book, we are seeing an increase in enrollment, though scattered based on geography and types of work. “Contractors in the private commercial market should expect sustained, but low to moderate growth for the foreseeable future,” Sznewajs confirms. “Projects dependent upon bank loans will remain difficult to bring to market as the financial sector continues to address issues with under-performing loan portfolios.” Zurich’s book supports the fact that many of the major projects within the private sector fueling our growth are funded directly by large corporations in the retail, office and hospitality sectors. However, budget
issues with federal, state and local governments continue resulting in unpredictable construction volume for the entire segment.

Subcontractors need to balance the increasing need for cash and credit during this time of extended payment terms from owners and stringent terms from lenders.

**Zurich observations**

One of the key risks we see going forward is how subcontractors and the construction industry will balance their increasing need for cash and credit during times when owners are demanding extended payment terms and lenders are being extremely cautious with extending credit.

Starting in 2009 in cases when defaults occurred, many general contractors were able to find replacement subcontractors at or below the original subcontract value. While the replacement value of the subcontract may have been stable, incoming subcontractors typically found quality issues in the workmanship of the defaulted subcontractor. This outcome was not surprising as subcontractors struggling financially tend to lose focus, reduce project oversight and lack quality management in order to simply finish work.

As subcontractors continued to reduce costs, such as eliminating individuals within their estimating and project management departments, their ability to fully understand the project and negotiate fair pricing suffered. Opportunities for missed scope, inadequate quality management and poor performance increased substantially. Subcontractors fought to keep top performers, but other areas such as support staff and office operations were cut drastically. This decreased the quality and efficiency of those employees still working with the business.

The predictable migration of general contractors toward market growth segments (i.e., out of private and into public, then back) has led to new challenges. Many of our customers now realize that it is not just their experience in a particular segment that contributes to their success, but also the experience of their subcontractors. This is an important distinction that was often previously overlooked.

Today, Zurich is experiencing a consistent increase in subcontractor defaults and early warning indicators from our customers (Exhibit #1), and we anticipate this increase to continue for the next 12-18 months. While a considerable amount of this activity is due to the decline in available work as well as increased competition, other causes of loss include quality, schedule and manpower issues (see Exhibit #2).
Managing Subcontractor Risk

What can general contractors do to protect themselves during this recovery?

While the current construction market remains unpredictable, there are signs of recovery in certain segments. One the most significant risks during this period will be how carefully subcontractors rebuild and manage their backlogs. While it is important to pre-qualify all subcontractors and suppliers on all projects, maintaining a consistent interaction and understanding of the health of these parties is vital to ensure on-time and on-budget project delivery. Kevin Burnett, Senior Vice President and Chief Financial Officer for Sundt Construction, Inc., stated, “Consistent communication between pre-qualification, pre-construction services and operations is critical to managing the risk of subcontractor failure. When the pre-qualification department finds that a subcontractor’s financial condition has deteriorated, it is important to communicate this to both pre-construction services for future bids and also to operations in the event the subcontractor is working on existing projects. The project team can then monitor the subcontractor more closely to ensure subcontractor’s employees, suppliers and second-tier subcontractors are being paid timely.”

Some notable exposures during this recovery period are:

**Pre-qualification standards:** More than ever, general contractors must ensure they are consistent in their pre-qualification and capacity management practices. An increase in potential work may indicate that standards could be relaxed, but this has never been farther from the truth given the current and future challenges.

**Supervision:** The ability to maintain adequate supervision on existing jobs while meeting the needs of new projects (with an emphasis on higher margin work compared to negative or no margin work in run off). One practical defense against this would be to incorporate a Key Staff provision into your contracts.

**Labor:** While unemployment figures remain high within the industry, many of the skilled supervisors and craftsmen have either begun to retire or find more stable industries for employment. Consequently, while key employees were likely retained during the downturn, the available employee pool is less experienced and/or qualified. As a general contractor, ensure you are monitoring and able to influence your subcontractor’s hiring practices.

**Quality and safety:** Both of these fundamental risk management elements are often neglected in times of increasing work and reduced staff. Maintaining and upholding these standards are paramount in a time when subcontractors are stretched thin. Own the entire jobsite; anticipate providing QA/QC and safety oversight for your subcontractors.

**Capital to meet costs:** Overextension is a significant issue in any recovery period, so frequent updating of key information such as backlog, cash and availability of lines of credit is essential. Ensure the subcontractor has enough working capital to perform adequately in the field. Ask only for the information needed to reduce the burden on your subcontractors.

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**Early Warning Indicators**

- Difficulty processing contract documents; providing timely, accurate and complete submittals
- Increased levels of change orders
- Frequent and unanticipated supplier turnover
- Ability to meet union/vendor responsibilities, receive pre-lien notices from the subcontractor’s suppliers and frequent delays in obtaining second-tier lien releases from subcontractors
- Fluctuating workforce size and morale without a scope-related cause; frequent management and labor resource issues
- Strained turnover ratios (payables and receivables)
- Reduced lines of credit
- Consistency of surety relationship, including quality of bond language and viability of surety provider

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Material management: Avoid paying for stored materials not in your possession. If payment for offsite materials is necessary, ensure you follow appropriate protocols for protecting your rights and access to these materials, including payment timing, offsite inspections, use of bonded warehouses and transfer of ownership. Request subcontractors provide you with the list of their suppliers and contact information for your project. Depending on your pre-qualification of the subcontractor, consider contacting the suppliers concerning their extension of credit to the subcontractor. In certain situations, consider joint checking or purchasing the materials directly from the supplier for the subcontractor.

Bids: Ensure the subcontractor has included all the items described in the scope of work in the bid documents. Due to staffing and time management challenges, arguments and time delays often occur when subcontractor bids do not include certain work elements. Consider doing your own in-house take-offs and use them as a benchmark for subcontractor quantities and pricing. Be very cautious of low estimates and pricing by taking careful steps to vet them appropriately, especially during lump sum bidding environments.

Complexity of projects and delivery methods: Construction is more complex in nature, and new methods of addressing these challenges are needed. Our claims reflect this activity, and specific issues with scheduling and coordination appear frequently as areas of improvement. As a result, we have developed Schedule Enhancement Solutions (SES), a prospective approach to project scheduling and controls as it relates to subcontractor default. SES is a collaborative effort between Zurich-provided experts and our customers’ in-house scheduling staff. Zurich Risk Engineering can help identify the challenges faced by our customers and address such risks to help mitigate defaults.

Exhibit #1 – Annual Subguard Default Frequency Trends

* Annual Claim Notices as % of six-year average (as of 04/30/12, projected through year end)
### Exhibit #2 – Subguard Default Experience (Zurich data through 12/31/2011)

<table>
<thead>
<tr>
<th>Cause of a Subcontractor Default</th>
<th>Percent of Claims</th>
<th>Value of Claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Distress</td>
<td>53%</td>
<td>44%</td>
</tr>
<tr>
<td>Quality (include warrant/defect)</td>
<td>15%</td>
<td>27%</td>
</tr>
<tr>
<td>Manpower</td>
<td>14%</td>
<td>13%</td>
</tr>
<tr>
<td>Schedule</td>
<td>13%</td>
<td>12%</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>5%</td>
<td>4%</td>
</tr>
</tbody>
</table>
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