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Insurance Policies vs. Surety Bonds: Similarities and Differences

I. What is Covered Under Subcontractor Default Insurance (SDI) and Surety Bonds

Subcontractor Default Insurance (SDI)

Subcontractor Default Insurance (SDI) is the first-party insurance that inures to the benefit of the insured (general contractor). The policy requires that the insured either declare the subcontractor in default or terminate the subcontractor. The coverage is interpreted by the insuring agreements contained within the policy including endorsements and exclusions. SDI policies in most instances have a substantial deductible that is applied against the loss. As such, the insured has a vested interest in the outcome of the claim. Unlike a Surety Bond, the insured has complete control on how they wish to complete the project. They can either relet the work to a new contractor, supplement the work of the defaulted subcontractor or complete the work themselves-- all of which is prescribed in the policy. The SDI policy will also indemnify the insured for its direct costs to complete the project which includes unpaid labor and vendors, the cost of labor and materials to complete the project and the cost to repair and replace defective work of the defaulted subcontractor which includes the subcontractor's warranty obligations.

SDI policies are non-assignable as such only the named insured can make claims under the policy. The SDI policy is project specific, and each project enrolled in the SDI policy must be endorsed. Each project has its own limits of coverage. The enrolled project allows the insured to insure it's subcontractors for either the full value of their subcontract or a percentage of the value of the subcontract. Most SDI policies will allow the contractor to either enroll the subcontractor into the SDI policy or bond the subcontractor, but they cannot do both.

If the defaulted subcontractor contests the proprietary of the default by the insured and proceeds with an action for wrongful termination and prevails, the insured must reimburse the insurer for all costs the insurer incurred arising from the claim.

Surety Bonds

Surety Bonds are a tri-party contract with the Surety, its Principal (contractor) and the obligee (owner). Surety Bonds are vastly different than SDI policies and are often misunderstood. Surety Bond coverage is defined by the terms of the bond, the contract and on

public work projects specific statutes and ordinances that set forth the Surety's obligations. The claim professional must understand contract law to interpret the bonds requirements which incorporate the construction contract into the surety bond.

Payment Bonds pay for the unpaid material suppliers and laborers of the bonded subcontractor.

Performance Bonds can either be issued on public or private projects. Performance bonds have specific terms that set forth the Surety's obligations. The most common performance bond form is the A-312. This form has been approved by the American Institute of Architects and is widely used. This form also prescribes conditions that must be followed by both the Surety and the obligees for coverage to be affected.

Public Work Bonds are prescribed by statute on all public, state, and local contracts and require bonds to be posted to protect the public, state and local governments from losses caused by the default or termination of contractors. This covers both unpaid vendors and labor of the defaulted contractor. Federal projects are governed by the Miller Act which sets forth the Surety requirements for federal projects. These rules can be vastly different than state and local public work bonds as federal precedent is different in the various districts throughout the United States. The completion of federal projects is governed by the Federal Acquisition Regulation (FAR), which sets forth how a federal project can be terminated and prescribes the Surety's options to complete the project.

II. Claims Handling under SDI and Surety Bonds

Subcontractor Default Insurance (SDI) Claims Handling

SDI policies require the insured to notify the insurer as soon as possible once the determination has been made to either declare the subcontractor and default or terminate the subcontractor. Upon receipt of the notice of default or termination, the insurer must acknowledge the claim and send the insured a proof of loss form to enable the insured to present its claim. The SDI policy will prescribe the coverage, the deductible, project, and limits for the loss of the insured incurred. Upon receipt of the completed proof of loss, the insurer will verify the coverage and confirm that the loss was for the scope of work of the defaulted subcontractor. The loss will then be subjected to the deductible. Direct and indirect costs must meet the requirements of the policy for the insured to have coverage.

Direct costs are the actual costs the insured incurred while completing the project including the payment of unpaid vendors and labors as well as the payment of any liens while on the project. The insured controls the relet process including procuring replacement subcontractors and assessing defective work.

Indirect costs are generally defined within the terms of the SDI policy but include such items as liquidated and delayed damages, delayed costs, extended office overhead, and other costs and impacts (excluding direct costs) that incurred caused by the defaulted subcontractor while completing the project.

It is the responsibility of the SDI claim handler to confirm coverage and to work with the insured so that the completion costs for both direct and indirect are for work performed by the defaulted subcontractor. It is also important that the insured take all efforts to mitigate the damages caused by the subcontractor's default.

Surety Bonds Claims Handling

Unlike SDI claims, the Surety bond claim handler is responsible for managing the performance bond loss by determining the correct course of action to mitigate the potential loss to the Surety. For private performance bonds, the bond form may prescribe how the Surety may precede to complete the project. Generally, the Surety has three options: First, the Surety can complete the project by engaging the completion contractor and procuring the contract funds from the obligee to offset the completion costs. Second, the Surety can elect to engage their principal and finance the principal to complete the project. Third, if the Surety elects, they can allow the obligee to complete the project with the understanding that the Surety will pay the obligee for any loss the obligee may incur in completing the project.

Public performance bonds are mandated by statute and within those statutes, the Sureties completion obligations are defined. On federal projects, the Miller Act and the federal acquisition regulations defined how the Surety may proceed.

The biggest difference between SDI coverage and Surety coverage is that SDI insured controls the completion and mitigation of the claim and coverages defined within the terms of the policy. Surety's control is in how the claim is handled, and the mitigation of the loss is responsible of the claim handler. The Surety's rights are defined by the terms of the bonds and contracts as well as applicable statutes and precedent law.

III. Subrogation

In Subrogation, the insured and insurer must affect its recovery against the responsible third-party that may have caused the loss. This applies to both SDI and Surety.

SDI Subrogation

The difference is the SDI policy sets forth how the subrogation is implemented, and that the insurer retains 95% of the first recovery against the responsible third-party. The SDI policy allows the subrogation to be in the name of the insured or the insurer. The insurer has the right to accept or reject any settlement offers. The insured is not required to reimburse the insurer.

Surety Indemnification Subrogation

Unlike SDI, the Surety is entitled by indemnification and subrogation to recover from all responsible parties that may have caused a loss to the Surety. The Surety is entitled to collect 100% of its loss first and any recovery more than Surety's loss may be given to its principal at the discretion of the Surety. Also, principals execute a General Indemnity Agreement (GIA) which requires the indemnitors to fully reimburse the Surety for its losses, including its attorneys and consulting fees.

IV. Conclusion

Both SDI and Surety are intricate parts of the contractors ability to spread risk and to mitigate its potential exposure to financial damages. Both SDI and Surety are useful tools to accomplish the needs of the contractor to protect itself from losses caused by it's nonperforming subcontractors. SDI allows the contractor to control the loss under its own terms and provides a faster course of action to complete and mitigate its exposure on projects with the understanding that they retain a financial interest in the claim process through the deductible.

Surety bond coverage generally indemnifies the contractor for its loss with the financial risk being placed on the Surety. Because of this, the Surety has the right to control the loss and to make the determination on the best course of action to mitigate its loss. The Surety may take a longer time to complete the projects. However, they assume the risk and are entitled to take the best course of action in its interests.