



Be on Guard for Subguard

The partially self-insured competitor to traditional subcontractor bonding called Subguard has really taken off in the last two years. All over the country with contractors big and medium we have seen subguard being pushed. We thought we should give you some advice and some warnings before you let your contractor sell you this particular product. Even though Subguard can be a good alternative traditional bonding and can actually result in a reduced cost to the Owner and the project, because of its very nature Subguard can be overpriced and nothing more than a way for your contractor to make an extra fee. So what is Subguard?

Subguard is an insurance policy taken out by a contractor or Owner against Contractor and/or subcontractor default. This particular insurance policy has a very high deductible. The contractor negotiates with the subguard insurance company the particulars of the payment plan but typically about one third of the payments made go to the insurance company for the insurance companies risk and two thirds go into an interest bearing reserve account held by the insurance company in the contractors name. Each contractor is incentivized to over-collect and underpay just like they are if they are largely self-insured for workers compensation and general liability insurance. We have seen contractors quoting subguard payments at 1.75% of subcontractor amounts when the average bond payments would be in the 1% range. We have

also seen contractors trying to collect subguard premiums from owners on purchase orders and subcontracts that they never would have considered bonding. We also have seen contractors failing to use their own subguard reserves when subcontractors have defaulted. One recent audit had the contractor replacing a subcontractor after a bankruptcy and charging the Owner \$76,000 more for the replacement subcontractor even though the Owner had paid over \$500,000 in subguard premiums to the contractor.

We believe that the moneymaking opportunities of subguard are going to be too much to ignore for many contractors. It is up to you as an informed Owner to analyze the subcontractor default risk and negotiate the best price. Additionally, after purchasing subguard you must enforce the terms of your agreement and not let your contractor spend your money to fix subcontractor default problems.

Subcontractor Change Orders Without Totals

We recently audited a major national contractor, which did not include an original contract amount and adjusted contract amount on its subcontractor change orders. Why would a contractor not show the adjusted subcontract amount on its change orders? Maybe it's that the contractor does not want an Owner or auditor to be able to tell what the actual contract values are. This very sophisticated contractor could sort its job cost and subcontract cost in a myriad of

ways. By including just certain subcontract change orders (Not including all the credits and backcharges) in some sorts the cost could appear higher than actual. If you think you might have this problem, speak up.

Additional Fee for Self-Performed Work

It has become common in parts of the country to see contractors request additional fee for self performed work. This trend seems to have picked up steam as contractors that actually did some trade work began to differentiate themselves from those that brokered 100% of the trade work to subcontractors. Of course the basic arguments for additional fee does contain some logic; an Owner would pay a higher markup to a subcontractor and that there is some additional overhead required in the performance of trade work. Logically, then the reverse would be if work can't be self performed and does not require additional overhead then no additional fee should be paid. You might be surprised when you ask the contractor to define what constitutes self-performed work. Recently we have heard a contractor explain that in addition to carpentry they intended to charge a self performed fee on clean up labor, dumpsters, labor for OSHA protection and weather protection. While this example may seem absurd we have almost never seen a contractor that was given an extra fee on self performed labor or work separate clean up as a non self-performed item. Referring back to our original assumption, since miscellaneous clean up can not be subcontracted easily and is not a drain on overhead then no additional fee should be allowed and your contracts should be clear on this point.

Should Contractors be Responsible for Allowance Overruns?

The basic language in the AIA contracts and most other construction contracts states that allowances are to be reconciled to actual cost by a change order. If there is an overrun the Owner adds to the contract and an under-run decreases

the contract amount. Both of these events are at no risk to the contractor. This especially makes sense when the Owner or Architect establishes the allowance amount or when the scope has not been defined to any reasonable degree. But, should the same hold true when the contractor is the one establishing the allowance amount or if the scope is reasonably defined but the exact cost to the contractor has not been confirmed? Additionally, should the contractor bear some responsibility in purchasing the allowance work as efficiently as possible?

Unfortunately we have seen two projects in the last couple of years where certain contract allowances were exceeded by many millions of dollars. In some cases the contractor was aware of the insufficiency of the contractor established allowance amounts prior to contract and yet did not inform the Owner. In another case the allowance work was all done T&M with unskilled laborers, we assume because any cost overruns would be paid by the owner.

Next time you are calculating your contract GMP, consider if your allowances are clearly defined as to the scope (labor and material, labor only, fixtures, fixtures and pipe, etc.), are truly unknowns, are clear as to how they will be bought out, and if the scope is mostly known and if the allowance was estimated by your contractor, consider capping the allowance as a not to exceed. If the contractor wants to add a little to the allowance amount to make it a not to exceed, so what. All of the risk in not capping the allowance is on the Owner and if the allowance does actually cost less then a deductive change order is in your future.

Contract Review

As always, we will be glad to review any contract you may be considering. While not a substitute for review by your legal counsel, we are in a good position to spot potential problems due to our extensive exposure to the results of different contract clauses. Please call for further information.