Notice and reporting under the SDI Policy

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Effectively managing subcontractor performance risk has many layers. Our Subcontractor Default Insurance (SDI) partners rely on the protections of the SDI policy as the “last defense” for mitigating the impact of subcontractor defaults. We often field questions or have concerns regarding the timing of processes associated with placing a subcontractor in default and notifying us of the situation. This paper will explore and provide guidance for a number of common questions, including:

- When is a subcontractor considered to be in default?
- When should subcontractor default letters be issued?
- When should the SDI carrier be put on notice?
- Why is timely notification important? Can it affect my coverage?
- Do your internal processes appropriately support proper carrier notification?
- Should you submit notices even earlier out of abundance of caution?

What do you do if a subcontractor defaults?
Provisions of the Subcontract Agreement

Regardless of default protection that the General Contractor (GC) may have in place, administering the terms of the subcontract agreement is the starting point for managing an escalating subcontractor performance issue. You can also ensure that notification to your SDI carrier is timely and proper by reviewing the default provisions of the subcontract agreement. The SDI Policy considers the terms of your subcontract agreement when determining when a default has occurred. Therefore, if you have experienced challenges with timely notifications, a natural place to begin is to review the default provisions of the subcontract agreement to determine if changes to the language of those provisions are needed. Default provisions that provide clarity about when a default has occurred and a clear timeline to cure before implementation of remedies also assist in knowing when notification under the SDI Policy is required.

**Scenario A**

The most common language we see within subcontract agreements requires that the GC first issue a Notice to Cure letter giving the subcontractor a specified amount of time to cure and then later issue a separate Notice of Default letter defaulting the subcontractor for failure to cure and imposing remedies. This language is preferred because the subcontract agreement has a well-defined period to cure followed by a clear default. The well-defined time periods for cure and default make it easier for you to identify when the formal default has occurred as well as when notification under the SDI Policy is required.

**Example 1:**
On June 1st, the owner notifies the GC that the steel columns are not consistent with the shop drawings. On June 2nd, the GC sends a Notice to Cure letter to the subcontractor responsible for the fabrication and installation providing the subcontractor with 48 hours to develop a plan to cure those deficiencies. On June 5th, the GC sends a Notice of Default because an adequate plan was not provided. This letter notifies the subcontractor that the GC will be hiring a replacement subcontractor to redo the work and back charging all costs to the defaulted subcontractor. In this example, it is clear that the default occurred on June 5th.

**Example 2:**
Same as example 1, except the subcontractor makes some effort to fix the columns for a few weeks, which ultimately proves to be insufficient. On July 15th, the GC sends a Notice of Default notifying the subcontractor that the GC will be hiring a replacement contractor to redo the work and back charging all costs. In this example, it is clear that the default occurred on July 15th.

**Table of Events**

<table>
<thead>
<tr>
<th>Event</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1</td>
<td>Problem identified</td>
</tr>
<tr>
<td>June 2</td>
<td>48 hour notice to cure letter, plan requested to cure deficiencies</td>
</tr>
<tr>
<td>June 5</td>
<td>Sub has not provided an adequate plan to cure</td>
</tr>
<tr>
<td>June 3 - July 14</td>
<td>Default letter sent to sub indicating GC’s plan to remedy and that sub will be responsible for the costs</td>
</tr>
<tr>
<td>July 15</td>
<td>Sub effort to cure, ultimately determined insufficient</td>
</tr>
</tbody>
</table>

**Different default dates and therefore notification requirements result from different circumstances.**
Scenario B
Another common variation on the language we see within subcontract agreements requires that the GC issue a “Notice of Default with time to cure” letter placing the subcontractor in default followed by a specified amount of time to cure before remedies can be imposed. This language is less preferred because we often see a period of time pass where it is not clear whether the subcontractor has cured the deficiencies and/or what actions the GC is taking to address the problem. In many cases, there are multiple letters issued to the subcontractor and a long paper trail - and perhaps time period - before remedies are finally imposed on the subcontractor. Unfortunately, given the language of the subcontract agreement, waiting to notify your SDI carrier until the last notice might be untimely. If your subcontract agreements utilize this type of language, notification under the SDI Policy should be given when the first Notice of Default letter is issued, even if the subcontractor ultimately cures the deficiency.

Example 3: On June 1st, the owner notifies the GC that the steel columns are not consistent with the shop drawings. On June 2nd, the GC sends a Notice of Default with time to cure letter to the subcontractor responsible for the fabrication and installation providing the subcontractor with 48 hours to develop a plan to cure those deficiencies. On June 5th, the GC sends a Notice of Default because an adequate plan was not provided. This letter notifies the subcontractor that the GC will be hiring a replacement subcontractor to redo the work and back charging all costs to the defaulted subcontractor. In this example, it is clear that the default occurred on June 2nd.

Example 4: Same as example 3 except the subcontractor makes some effort to fix the columns for a few weeks, so the GC does not provide the SDI carrier notification of the default. However, the subcontractor’s efforts are ultimately insufficient and they abandon the work. On July 15th, the GC sends a letter notifying the subcontractor that the GC will be hiring a replacement subcontractor to redo the work and back charging all costs. In this example, there can be a lack of clarity about when notification to the SDI carrier should occur. Per the terms of the subcontract, the default occurred on June 2nd, but the GC would not have known the deficiencies would not be cured until July 15th. Because the subcontractor has been placed in default as part of the notice process, the notice to your SDI carrier is required based on the June 2nd letter.

Example 5: Same as example 3 except the subcontractor successfully cures the default themselves and/or accepts the back charge for costs the GC incurred to cure the default for them. The default in this case also occurred on June 2nd, even though it was later cured. In this case, talk to your AXA XL Underwriter to determine if additional clarity around the status of the default is needed.

Note that in each of the examples, if GC has begun to incur costs, our recommendation, and in some cases a policy requirement, is that you notify your SDI carrier as soon as costs begin to be incurred to cure a default, whether the subcontractor is notified or not, in order to preserve rights under SDI policy.
The context above regarding how subcontract language – and the administration of its terms – affect the date of default is important within the framework of the SDI policy, because date of default is the trigger for notification requirements. You can ensure that notification is timely and proper by reviewing your specific SDI Policy and understanding the effect of the subcontract agreement provisions. The SDI Policy contains some key requirements: (1) the notification to the carrier needs to be made in writing; and (2) the timeframe in which notice must be given. To satisfy the SDI Policy requirements and trigger the policy provisions, you will need to provide a copy of the Notice of Default, a copy of the subcontract agreement, and a completed “AXA Notification of Claim/Potential claim” form.

In some cases, your SDI policy may include language requiring notification to your SDI carrier in the event a specified sum of money has been incurred and not reimbursed by the subcontractor, even prior to the subcontractor being placed into default. In those situations, you would also need to provide timely notification to the SDI carrier once the threshold was reached even though you have not yet placed the subcontractor in default. Verbal notification to the carrier is insufficient and reporting too late could impair your rights under the SDI Policy or bar coverage altogether. Given that there are many moving parts in these situations, it is very important to develop your internal processes effectively. Consider the following to address common problems:

- **How do you ensure that SDI carrier notification will be timely?**
  - Upon receipt of any communication issued in accordance with the terms and provisions of the subcontract agreement, the risk manager should review the date of default and calculate when notification to the SDI carrier is required. The risk manager or other appropriate level of authority within your organization should immediately request that project teams understand the implications of these actions as well as all communication that should occur in these cases.

- **Who completes the SDI carrier notification form?**
  - Notification forms should be completed at the appropriate level of your organization. Typically, this would be the risk manager, legal, CFO, or other C-suite point of contact. If the project team will be placing a subcontractor on notice of default/potential default, it is crucial that they simultaneously provide that information to the appropriate party within your organization, so that the SDI carrier notification form can be completed and delivered timely. Ensure that project teams understand the implications of these actions as well as all communication that should occur in these cases.

- **How do the appropriate parties in your organization (risk management department, senior management, etc.) know that a subcontractor has filed for bankruptcy or is being liquidated?**
  - If legal notices are directed to the legal department, an outside lawyer, or your prequalification group, consider requiring that the risk manager or other appropriate level of authority within your organization also be informed that a legal notice has been received. Notification to the SDI carrier is also required when the subcontractor is insolvent. The window of time to provide notification starts the day you become aware that a subcontractor has become insolvent, and appropriate parties within your organization need to be involved immediately.

Many other variations exist. The overall takeaway is that GC’s should look closely at their subcontract language and identify the correct default terms and provisions. If the default terms and provisions vague or ambiguous, consider updating your subcontract and training your project teams to make this process clearer for everyone involved.

**Scenario C**
Another variation that we see within subcontract agreements includes language indicating that the subcontractor is in “substantial breach” prior to being in “material breach”. This language is less preferred because the subcontract agreements often lack well-defined periods to cure “substantial breach” or “material breach” and may or may not include placing the subcontractor into formal default and because the language references a breach of the subcontract agreement, which then requires notification to your SDI carrier. Additionally, subcontractors are more familiar with the term “default” and may not appreciate the significance of being placed in substantial breach versus material breach. If your subcontract agreements utilize this type of language, notification under the SDI Policy might need to be given when the subcontractor is placed in substantial breach, even if the subcontractor is never placed in material breach.

**Scenario D**
One final scenario worth mentioning is that, even if your subcontract Notice of Default language is clear in terms of how your project teams should administer it, there can be inconsistencies in the practical application. We always recommend that project teams engage risk management, legal, and senior members of the GC’s management prior to issuing any Notice to Cure or Notice of Default letters. Following are a few common issues we see:

**Example 6:** The project manager or superintendent, after growing frustrated with a lingering subcontractor problem, writes an email to the subcontractor and in laying out the open issues they include words like “breach of contract”, “default”, or other terms which may or may not have legal bearing as it relates to the subcontract. As a best practice, we recommend coaching your project teams to avoid using this language within an email and instead use the formal default provisions of the subcontract agreement to state their case. The subject line of the attached letter should also clearly state which type of letter it is as outlined in the default provisions of the subcontract agreement and the body of the letter should also reference those provisions. Providing a template letter for your project teams to use in both scenarios is another best practice which drives consistency.

**Example 7:** As an extension to example 6 above, the email or attached formal letter typically refers to the subcontractor as being in default or not having cured their past defaults. Again, we would encourage not utilizing the term “default” in any written communication unless the sub was placed into formal default at an earlier date. Such references to a past default may complicate the timely notification provisions that we will discuss below.

**Example 8:** The project team sends a subcontractor a formal letter but does not use the words “Notice to Cure” or “Notice of Default” as may be required by the subcontract agreement and instead just references other terms or provisions within the subcontract agreement. As a result, confusion arises as to whether the subcontractor is in default.
Importance of Timely Notification

Timely notification is important for several reasons. First, a timely notification will prevent any coverage issues pertaining to notice. For example, if the SDI Policy requires notification be given within 30 days of a default, the possibility of being barred from coverage increases the longer you wait.

Second, notification allows you to leverage the resources available as part of your SDI program. AXA XL Risk engineering and your Broker can offer consultation to help mitigate the impacts of the default, potentially before any money has been spent, thereby lowering the amount of damages. Risk engineering and your Broker can also help you develop your strategy for documenting the claim appropriately. Claims managers, with the support of risk engineering and consultants, can help you navigate the claims process to ensure efficiency and accuracy so that you can achieve the highest possible yield on your claims as quickly as possible. Claims managers can also play an integral role in supporting the legal questions and recovery/subrogation expectations of the policy. The longer you wait to provide notification, however, the less ability we have to advise you on contemporaneous documentation or managing challenging situations.

Finally, notification can help lower the ultimate cost to your company, depending on the specific terms of your SDI program. Early reporting endorsements and retroactive premium agreements do not change the overall compliance requirements with the notification provision but may provide for the waiver of the co-payment if notification is provided within 5 business days of the default. The intent and expectation of these provisions is that early engagement, focus, and action on subcontractor default matters – both internally within your organization as well as externally with your SDI carrier – will result in improved mitigation of the matter. Our current tracking of claims supports this assumption – those that follow the Early Reporting requirements have on average resulted in a 12% lower loss (based on multiplier).

In recognition that this early collaboration is effective, the policy provides a monetary incentive for early reporting via waiver of the co-pay. The example below demonstrates how timely early reporting can save your company significant funds:

**Example of Early Reporting Impacts**

<table>
<thead>
<tr>
<th>Notification Impact</th>
<th>6 days after default notice provided</th>
<th>5 days after default notice provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Verified loss</td>
<td>$2.25 m</td>
<td>$2.25 m</td>
</tr>
<tr>
<td>Deductible</td>
<td>$1 m</td>
<td>$1 m</td>
</tr>
<tr>
<td>Co-payment (20% of next $1.25 m)</td>
<td>$250 k</td>
<td>$0</td>
</tr>
<tr>
<td>Net payment</td>
<td>$1 m</td>
<td>$1.25 m</td>
</tr>
</tbody>
</table>

If your SDI Program contains early reporting incentive, you will need to carefully consider whether your process for notification is efficient enough to provide notification within 5 days so that you do not miss out on the co-payment waiver.

Precautionary Notification

Lastly, we are often asked how it is viewed if a partner submits notices on perceived smaller issues that will likely “go away” or why it would be useful to provide early notices. The SDI Policy allows for precautionary notification even before knowing that damages will result and can have a number of benefits, such as:

1. Avoiding any question about whether the notification was timely; (2) helping you determine if your company is managing difficult situations without impact; (3) capturing the benefits of your risk engineer’s experience through insight into the default situation; and (4) efficiently and accurately documenting the costs involved to be included in a change order to an owner, defaulted subcontractor, attorney representing your company in litigation or arbitration, or SDI claim. Any advantages or disadvantages of providing precautionary notification should always be discussed with your broker.

We encourage submission of notices as an opportunity to collaborate, and, in general, seeing these issues managed successfully through your typical practices is viewed positively. However, providing notification for every subcontractor who is having issues on the project might be too great of a burden. We understand that formal Notice to Cure letters are often used as a tool to communicate to the subcontractor that the situation is serious, needs immediate attention, and that they are expected to respond. In situations, however, where you feel that the subcontractor will not respond fully or appropriately, you may want to provide precautionary notification to your SDI carrier before the situation deteriorates to a default and/or termination.

For example, you may want to consider providing precautionary notifications in the following situations:

1. the subcontractor has received two or more letters asking them to cure deficiencies; (2) the subcontractor has agreed to being back charged for supplementation of manpower, use of joint checks for unpaid lower tiers or vendors, or other risk mitigation procedures; (3) the subcontractor is disputing any back charges to which they previously agreed; (4) the subcontractor has retained an attorney; or (5) you are considering a de-scope agreement with the subcontractor. This 5th example is particularly important, as it could affect the scope of a future claim.

In these situations, we can help you monitor the situation and your risk engineer can provide recommendations to help manage the situation and/or prepare for a possible default or termination.
In summary, timely notification of a default will protect your coverage under the SDI Policy and makes the most of your partnership with AXA XL. In order to understand when to provide notification: (1) know the terms and conditions of your policy, endorsements and related documents; (2) understand the implications of the subcontract language on notification; and (3) implement internal processes that support timely notification. If in doubt, err on the side of caution and provide precautionary notification. Data supports that early notification can reduce the cost of a default, and AXA XL’s risk engineers, claims managers, and underwriters are available to assist you.


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