



Prequalifying Subcontractors to Mitigate the Risk of Subcontract Default

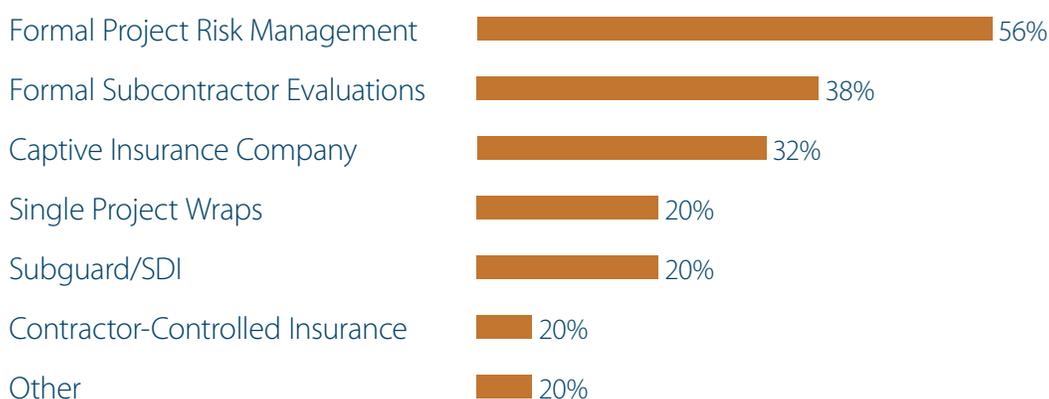
Subcontractor default remains a serious risk to general contractors. While not receiving as much attention as the lack of skilled labor in recent years, general contractors still identify subcontractor default as an area of significant risk in 2019. According to a recent Risk Management Survey* from the Association of General Contractors and FMI, general contractors rank subcontractor default as a current and future risk to managing a successful project.

To manage and mitigate this significant risk, 38% of the general contractors who responded to the survey reported the implementation of formal subcontractor evaluations as a new procedure in their risk management practice.

While subcontractor prequalification is not new to many, the statistics below demonstrate that many general contractors are still formalizing their internal process for vetting and selecting these key project partners.

Not all subcontractor defaults are preventable. However, a thorough prequalification program can help contractors avoid defaults by identifying preferred subcontractors that meet, or exceed, their operational and financial requirements. Prequalification considers financial, quantitative, and qualitative measures and assigns scores to a subcontractor to enable the general contractor to make a “go/no-go” decision on whether to use the subcontractor.

Exhibit 14. Please describe any new risk management tools that you have started to use in the last three years.



Source: 2019 AGC/FMI Risk Management Survey

* <https://www.fminet.com/the-2019-agc-fmi-risk-management-survey-executive-summary/>



One of the beginning steps in the prequalification process is communicating the intent of the process to the subcontractors. Many subcontractors will have experience with the prequalification process. However, it could be the first time for some subcontractors. Further, the financial information and documents are often a sensitive topic for subcontractors. General contractors should strive to communicate the purpose and goal of their subcontractor prequalification process with the subcontractors. Providing subcontractors with information on how a subcontractor prequalification process positively impacts all project participants can help ease an inexperienced subcontractor's concerns about providing the required information and documentation.

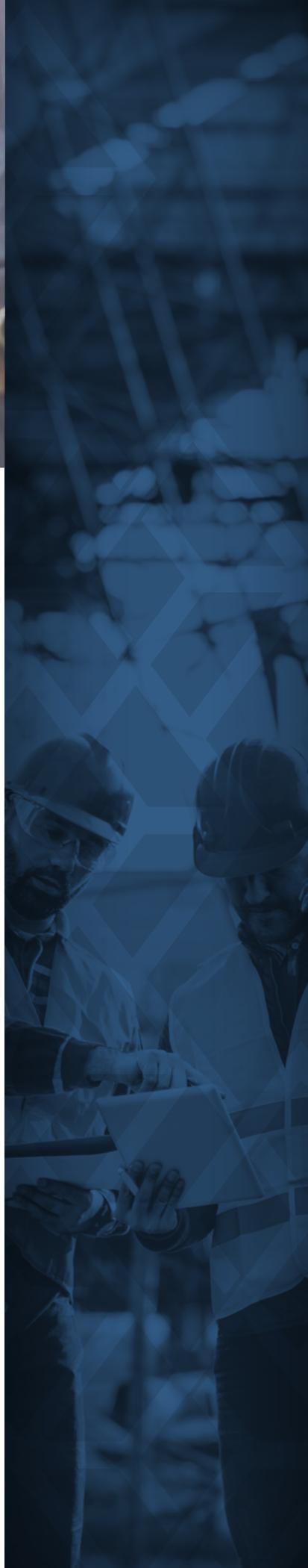
Questionnaires are generally used to obtain the initial information and documents from the subcontractors. Some key areas of the questionnaires are:

- Background information (contact information, years in business, form of business, licensure, and key personnel)
- Safety, quality assurance, and quality control information (does the subcontractor have a full time safety representative, a formal written safety program, a full time QA/QC representative, and a formal quality program?)
- Experience (history of projects, including the largest contracts completed under the current management and the type of contractor the projects were completed under, and current backlog)

- Claims and suits (has the contractor failed to complete any projects and are there any pending judgments, claims, or arbitration proceedings)
- References (trade, bank, and surety references)
- Capacity (what size and type of projects is the subcontractor best qualified to handle)

Key documents that should be obtained from the subcontractor include:

- Financial statements from the past two fiscal years (preferably audited or reviewed by a reputable CPA firm)
- Work-in-progress report
- Documentation regarding the subcontractor's line of credit from their bank or financial institution
- Safety manual
- Insurance certificates and endorsements (additional insured, primary non-contributory, and waiver of subrogation)
- Supporting documentation for safety history (OSHA forms 300A and 300, and 3-year EMR verification letter from workers compensation carrier)





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Once the information and documents are gathered, general contractors should implement a consistent and defined workflow to review the information and documents obtained from subcontractors. Establishing the selection criteria should be a cross-departmental strategic project, with priorities coming from upper management and getting input from estimating, purchasing, finance, and the field. Once the criteria are determined, a weighted scoring formula can be developed to help quantify the risk associated with each subcontractor. When determining a formula, it is prudent to consider the available resources, such as CFMA's Construction Industry Annual Financial Survey, the Risk Management Association's Annual Statement Studies: Financial Ratio Benchmarks, and Dunn & Bradstreet, Inc. General contractors could also avail themselves of any resources offered by their own insurance carriers and surety companies.

While a defined program and consistent application is critical to an effective subcontractor prequalification program, flexibility is also important. It may be helpful to set up threshold requirements for different types of work and sizes of subcontracts. Often, contractors will separate their subcontractor portfolio into high-, medium-, and low-risk categories based on single and aggregate work program parameters. Higher-risk subcontractors are generally held to the highest standard, with senior management making the ultimate decision. The scoring formula discussed above can help general contractors identify high-risk subcontractors. Further, a small trade subcontractor may not be able to provide all the required documentation and may still be the right subcontractor for the project. General contractors should remain flexible while not losing sight of the overall goal of obtaining the relevant information to make an informed decision.



Colin Chipman is a Surety Claims Advocate who assists our clients with risk management through contract review and developing risk transfer strategies. He also provides assistance with surety matters, including surety bond claims.

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