

RiskTopics

Subcontractor payment management guidelines

Zurich Resilience Solutions - Risk Engineering

Effective management and control of the subcontractor payment process plays a critical role in reducing and even eliminating the risk of losses due to subcontractor defaults.

Introduction

Zurich's claim data has shown that general contractors with top tier payment management practices have generally achieved exceptional results with regard to limiting or avoiding subcontractor default losses.

Discussion

Many subcontractors do not have the cash or credit lines to handle extended payment terms often required by contract terms, fluctuations in material costs or losses because of poor quality or non-conforming work. Therefore, general contractors should actively manage subcontractor default risk by using rigorous subcontractor prequalification and subcontractor payment guidelines to help keep projects on track.

Guidance

Subcontractor payment guidelines include the following:

- Do not overpay – subcontractors in financial difficulty have a habit of over-billing to stay afloat. Zurich's SDI claims data has shown that nearly 60% of defaulting subcontractors were overpaid at the time of default.
- Ensure an accurate schedule of values is provided prior to the start of work.
 - Do not accept a front-end loaded schedule of values.
 - Ensure that large lower-tier subcontracts are also broken down within the schedule of values. Consider requiring subcontractors to list all lower-tier subcontracts and purchase orders above a certain threshold amount.
 - Do not accept "lump sum" line items for lower-tier subcontractors.
- Require a notarized payment application, signed by the subcontractor principal, with units of installed work or percentage of total work installed for each line item.
- Establish a procedure for physically verifying work in place and confirming that it meets subcontract specifications and approved submittals. Require project manager and superintendent payment approvals.
- Utilize project-specific quality control plans to mitigate the risk of non-conforming work.

- Utilize material / equipment inspection forms and defined inspection procedures with a goal of 100% material verification and assign site staff responsibilities to ensure material and equipment delivered to the project site are inspected and approved to prevent the use of non-approved substitutions.
- Try to pay only for installed materials and equipment. However, if payment for stored materials is absolutely necessary, the following procedures should be utilized:
 - Obtain inventories and bills of sale along with proper insurance and bonding covering the full value of stored materials and any associated costs to replace if damaged.
 - Conduct factory or storage facility inspections to physically verify quantities / values and confirm proper tagging / labeling (with general contractor or owner's name) prior to approval for payment. Take photos of materials and labels.
 - Include the responsible architect / designer in the assessment and approval process.
 - Utilize off-site storage agreements stipulating all paid for materials and equipment are the property of the general contractor or owner (title and ownership), terms and conditions regarding storage and payment, insurance requirements, inspection rights and procedures, transportation, etc.
- Monitor and verify downstream payments. Require the submittal of conditional and unconditional lien releases from lower-tier subcontractors and vendors / suppliers. Periodically communicate with lower-tier subcontractors and vendors / suppliers to ensure payment receipt.
 - Initial payments to each subcontractor should require a conditional lien waiver and release from the subcontractor.
 - Each subsequent payment should require a conditional lien waiver and release for the current payment due and an unconditional waiver and release from the subcontractor and all lower tier subcontractors / suppliers for the prior month's payments. This process should continue until completion of the subcontractor's work. At that time, a final waiver and release should be obtained from all.
- Verify union payment obligations are current.
- Utilize joint check agreements as needed, especially for higher risk and nonperforming subcontractors. In addition, consider establishing a corporate policy that specifies a dollar limit for downstream payments to tiered subcontractors / suppliers above which joint checks are mandatory (for example, any tiered subcontractor / supplier payments over \$500,000 must be via joint check).
- Confirm receipt of relevant as-built drawings, material / equipment submittals and updated construction schedule information, along with current approved certificate of insurance prior to payment distribution.
- Maintain 10% or higher retention on high risk or nonperforming subcontractors / suppliers and do not reduce until project and risk management teams have assessed risk and concluded risk has been eliminated.
- Have the risk management team regularly monitor higher risk subcontractors financial and payment status (financial statement review, D&B rating, reference checks, bank data including line of credit, etc.).
- Have the risk management team conduct pre-construction and regular review meetings during construction with the project team to communicate and monitor higher risk or nonperforming subcontractors/suppliers.
- Do not issue payments based on a Letter of Intent or unexecuted subcontract agreement. Automate accounting system to withhold payments unless executed subcontract and current certificates of insurance are in place.

Conclusion

While subcontractor default isn't always foreseeable or avoidable, it can be minimized by instituting rigorous controls. Developing structured and robust prequalification and payment management processes can help create a win-win for both general contractors and subcontractors, while helping to ensure a history of projects delivered at the highest level of professionalism.

For more information on Zurich's extensive Risk Engineering and Sustainability services, please contact your Risk Engineer or visit us at [Risk Engineering and Sustainability Services | Zurich Risk Solutions](#).

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