



# COVID-19—An Analysis of Subcontract Performance Risk, Risk Mitigation, and the SDI Market

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As the construction industry enters new and uncharted territory as to how the COVID-19 virus may impact the performance of construction projects and performance security like Subcontractor Default Insurance (SDI), Aon's Construction Services Group is evaluating how the performance of the construction work may be impacted, certain risk mitigation strategies and how construction contracts and performance security like SDI may function in this new and unprecedented environment.

This analysis will highlight several risks and risk mitigation strategies regarding project performance, and related subcontract provisions which will likely be new territory for many general contractors and their subcontractors. As work on construction projects becomes more challenging as a result of COVID-19, it is increasingly likely that areas of contractual dispute will arise. You may find yourself considering contract clauses which have historically seen little use.

Importantly, questions of how SDI may respond in an event of subcontractor default will require close consideration.

Chief risks to the performance of the construction project include:

- health & safety concerns,
- schedule delays caused by labor or material supply chain disruptions,
- maintaining quality of production,
- potential subcontractor insolvencies which may occur as a result of the economic disruption caused by the COVID-19 outbreak.

## Health & Safety:

New ways to think about precautions to keep workers safe and establish clear protocol to prevent the spread of the virus at the project site(s) should be considered and mitigation strategies put in place. It is important that subcontractor labor feel safe at the worksite during this pandemic, and accommodation must be made to ensure that social distancing and proper hygiene are enabled and enforced. The following precautions should be implemented on every project and integrated into Health & Safety protocols and processes:

- Consider limiting workers on site to 50 persons within a given location or any confined place;
- Stagger work shifts to limit employee numbers working at the same site or in the same area at the same time;
- Stagger break times to minimize the number of employees on break at the same time;
- Add lunch trailers if needed to facilitate social distancing;
- Screen employees at the start of each shift, including asking questions about symptoms and exposure to higher risks (e.g., people who have travelled or had contact with others who are sick or have been traveling). Some employers are taking employee temperatures before starting work, although there are potential privacy concerns with collecting this information;
- Immediately send home anyone with symptoms of illness;
- Ensure employees self-isolate in accordance with public health directives;
- Consider the use of masks for workers who work in close proximity with others; masks are more effective in stopping spread of droplets vs. preventing absorption of droplets
- Ensure social distancing during safety meetings and hold such meetings outside;
- Promote proper hygiene;
- Ensure work areas, trailers, tools, and supplies are properly sanitized, and where possible, sanitize equipment daily
- Provide adequate hand-cleaning stations to the jobsite;
- Limit the number of people who travel in the same work vehicles;
- Allow office workers to work from home, where feasible;
- Limit access to office trailers;
- Limit numbers in smoking areas and lunch trailers.

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## Labor Disruption:

COVID-19 has the potential to cause widespread labor disruption, resulting in the potential inability of a subcontractor to perform the subcontract, or schedule delays and work re-sequencing. Any significant labor or work disruption may impact the project schedule, as well as efficient and quality progression of the work. As labor is staggered and projects re-sequenced, contractors should pay particular attention to production quality and ensure that QA/QC processes are strictly adhered to as well as to pay particular attention to subcontractor safety and quality. [Download](#) the specific insights on safety protocols from Our Construction Services Group.

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## Supply Chain Disruption:

The impact of COVID-19 on supply chain has been and will continue to be substantial. As the pandemic continues to spread across the globe, manufacturing and transport of raw and finished materials has been [impeded. increasingly difficult]. It is important for contractors to understand the full end-to-end supply chain on all construction materials, and in particular, long lead items imported outside of your local jurisdiction. Follow subcontractor downstream payments to evaluate whether those supply chains are reliable, and identify vulnerabilities for which subcontractors should plan. Perform concentration and aggregation analysis to determine whether your supply chain is disproportionately exposed to any particular region. This is an exercise that must be performed with regular frequency as the global supply chain re-organizes to cope with the pandemic disruption. With your subcontractors in this continually changing environment—what may not be a problem today could be a problem next week or next month. [Download](#) the Supply Chain Analysis Checklist for your use and consideration.

## Insolvency:

As a result of COVID-19, unprecedented restrictive measures have been implemented around the globe. Large segments of the global economy have simply been shut down. The effect on subcontractors, and their ability to perform their subcontract obligations, is of yet unknown. It is highly likely that hardship will follow, and enterprise resilience will depend on available financial liquidity. There is a very real threat to the solvency of subcontractors as the impact of the COVID-19 measures taken to contain the spread of the virus reverberate through the economy.

## Risk Mitigation:

There are several risk mitigation strategies that may be helpful.

- Frequent and transparent communication is a strong risk mitigation tool. This would include collective discussions with your peers and industry associations to discuss potential solutions to the most pressing issues you confront. Many industry groups host weekly calls to discuss current issues related to COVID-19 and impacts on construction projects and opportunities.
- Direct and transparent communication with Project Owners and Lenders is critical to form a true consensus partnership in resolving project impacts and disputes. This is an industry crisis that requires a holistic view on relief rather than an adversarial approach which may exacerbate short-term impacts and lead to increased insolvencies.
- Have frank conversations with your subcontractors to understand the challenges that they face to consider effective risk mitigation strategies. File contractual notices where appropriate, but continue to support subcontractors as they deploy resources to site.
- Perform a full risk assessment of your subtrade exposure. Evaluate the concentration and aggregation risk of all subtrades engaged and cross reference for risk factors such as
  - A.) credit quality (cash, borrowing availability, quality of receivables)
  - B.) critical path
  - C.) supply chain resilience (Tier 1, Tier 2, and lower tiers)
  - D.) geography and jurisdictional conditions.
    - o Continuous qualification of subtrades should be triaged on this basis and involve direct engagement and interviews with subcontractor leadership
- Monitor the financial condition of your current subcontractor base on an ongoing basis. The economic disruption of COVID-19 may continue to flow through a subcontractor's financial statements for at least 24 months and as such, continuous prequalification of enrolled subcontractors is important. Be sure to assess the impact of COVID-19 on subcontractors' other projects
- Understand what incentives and assistance may be available to your subcontractors at the state, local and national level to help mitigate financial loss.
- Increased project documentation is critical. Managing any COVID-19 cost or schedule impacts "after the fact" will require contractors to substantiate them via detailed cost and contract documentation, as well as accurate schedule data. Keep track of daily project logs and update your project schedules on a frequent and regular basis. As possible, consider having redundant copies (print and electronic), as feasible.

## Your Contracts in Action:

If circumstances arising from the COVID-19 pandemic impact the performance of your construction project, and the ability of your subcontractors to perform, several key contractual clauses could be triggered.

## Force Majeure:

Review whether your general contract and the subcontract contain a force majeure-type clause (*unforeseeable circumstances that prevent someone from fulfilling a contract*) A force majeure is a provision which excuses a party from the performance of the contract, typically for a period of time, as a result of its inability to perform arising *directly from* an event which is *unforeseen* and which *prevents* contractual performance. These clauses typically define the types of events which qualify as such a force majeure event.

It is essential that both elements exist—that the contract was executed when the force majeure event was unforeseeable, and that this event is actually preventing performance in some specific way. When considering whether this clause applies it will be important to consider:

1. The specific language of the force majeure clause (does it include epidemic or pandemic, public health emergency, state of emergency);
2. A demonstration that the event was unforeseeable;
3. A direct correlation between the force majeure event and its impact on performance;

4. A demonstration that the events are significant enough to prevent performance of the contract.

Typically, a force majeure clause will excuse performance—whether it is for a limited period of time or a complete discharge of performance depends on the language of the clause and the applicable law. As an example, if the COVID-19 pandemic is preventing a subcontractor from honoring its subcontract which requires the supply of specially fabricated material, if the subcontract contains an appropriately drafted force majeure clause which meets this event, the subcontractor could argue that COVID-19 has prevented the subcontracting party from performing its scope of work. This would presumably require a demonstration that the material cannot be supplied from any other source, and performance of the subcontract is prevented.

Further force majeure issues to consider in this example:

1. Does the force majeure clause specify rights and responsibilities once the clause is triggered;
2. Is there a limitation on remedies or damages;
3. If the period of inability to perform is limited; what are the respective rights and obligations of the parties.

## Termination and Other Clauses:

Certain contractual termination clauses may become relevant, and may allow the subcontractor to terminate the subcontract:

- Consider contractual termination clauses in the general contract and the subcontract and the intersection of those clauses. A subcontract may contain a termination clause which may allow a subcontractor to terminate a subcontract if a project has been stopped or suspended for longer than a 30-day period as a result of an order of a court or governmental authority having jurisdiction, or as a result of the declaration of a national emergency or other governmental act through no fault or act of the subcontractor. Carefully determine that the order of the governmental authority having jurisdiction over the project has delivered the order to stop work on the project. Most state and local jurisdictions in the US consider construction “essential” and the particulars of any such governmental order are critical in this analysis. As always, consider the exact language of the clause itself carefully.
- A termination of this type would typically entitle the subcontractor to receive some measure of recovery. This may include payment for work executed to date, and all loss, cost or expense in connection with the work, including de-mobilization costs. In some instances,

the clause may provide for reasonable overhead and profit on work not performed. Again, any entitlement to payment will be subject to the language of the subcontract clause.

- It is important to carefully review the contract and subcontract provisions because the language of the clauses will govern the rights and responsibilities of the parties.

Other contract provisions to consider when project performance has been impacted include:

- **Price escalation provisions** in both the general contract and the subcontract; and
- Provisions covering **schedule, delay, claims or a request for equitable adjustment** in both the general contract and the subcontract.
- In these instances, it will be very important to consider not only the time impact, but also the increased cost of performance of the project. Written notice is a key feature of these clauses and should be carefully considered. Absent a written contractual provision, subcontractors unable to perform may look to invoke common laws of contract such as impossibility of performance.

## Federal Projects:

In the case of federal projects governed by the Federal Acquisition Regulation (FAR) regulations, there are FAR regulations which may be relevant including:

- FAR 52.249-14 on federal cost reimbursable projects which includes as non-compensable ‘Excusable delay’ epidemics and quarantine restrictions.
- FAR 52.249-10 on federal fixed-price contracts which allows for non-compensable delay for epidemics and quarantine restrictions.

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## How May Performance Security Respond:

How Subcontractor Default Insurance may respond in the event of a subcontract failure in this environment is a complex issue.

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### First, Evaluate the Subcontract and the SDI Policy :

1. Consider the definition of subcontractor Default of Performance in the SDI policy as well as the default provisions of the subcontract itself;
2. Consider whether there has been a failure to fulfil the terms and condition of the subcontract (a subcontractor “Default of Performance” under the SDI policy) with reference to the subcontract language; and whether any subcontract provision (like a force majeure provision) would excuse the performance of the subcontract in whole or in part;
3. Consider whether a termination clause or other subcontract provision allows the subcontractor to terminate the subcontract as a result of an action taken by a governmental authority. Carefully consider and review the action taken by the governmental authority to determine that it meets the criteria of the subcontract and whether the governmental authority issue an order mandating action relative to the project and the Subcontract at issue.
4. The insolvency of a subcontractor typically has many causes and circumstances which contribute to financial failure. The subcontract

will most likely have very clear terms that an insolvency of a subcontractor acts as an automatic event of default under a subcontract;

5. Review the **Exclusions of the SDI policy** which typically do not include any language which specifically excludes coverage for Loss arising from widespread epidemic, pandemic, or public health emergency. The policy exclusion language may refer to “actions taken by government authority.” That language should be carefully reviewed in its entirety to determine whether the phrase “or action taken by governmental authority” is meant to refer to only those governmental actions which are *similar or related to* the specific actions that precede the phrase “action taken by governmental authority.”
6. As noted above, a careful analysis of what constitutes action taken by governmental authority is important.

# The SDI Markets Response:

Lastly, as we work through an unprecedented and challenging period of economic and supply chain disruption, the SDI market will undoubtedly be impacted.

- As of this report, SDI carriers are considerably focused on providing their customers guidance and assistance on subcontractor risk mitigation tools, understanding the importance of assisting customers with risk mitigation.
- Effective communication with the SDI carriers will be critical and we are committed to serving our clients in maintaining an open dialogue.
- Regardless of the uncertain economic environment, SDI carriers will respond to the unique circumstances of each claim and evaluate each one on its merits.
- Negative SDI results can drive changes in overall risk appetite and highly critical reinsurance support with implications for capacity, rate and exclusions.

Aon is maintaining frequent real time communication with myriad SDI carriers to understand their response to the current environment. We plan to provide you with an updated SDI market report detailing impacts to the SDI industry resulting from COVID-19 in the coming weeks as we continue our dialogue with the SDI markets and developments on the ground in the US and Canada.

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