

## SECTION II, Chapter 06 (Version 10.16)

# Selection of Subcontractors – A New Area of Risk Management



### Introduction

Like many other facets of the building industry, management of subcontractors has also become increasingly complex. For example, on the one hand, government regulations have attempted to increase the responsibilities of general contractors for their subcontractors. On the other hand, insurance company programs have attempted to shift some of the risks from the general to their “subs.”

Because of this increasing complexity and the costs that invariably go with such complexities the selection of subcontractors is one that the Nationwide Contractors’ Alliance (NWCA) considers an increasingly important element in its efforts to provide a package of products, services, educational material, and other resources that will have a substantial impact on liability insurance costs of both contractors and subcontractors and hence ultimately on the price of the product being delivered to the public.

Obviously, all general contractors want to hire “good subs” who come in on time, do their work efficiently, and complete their assignment at the price, quality level, and schedule quoted. However, the reality is that not only is this not always the case. Even with “good subs,” there are substantial opportunities for builders to decrease their risks and costs by improving the management of their subcontractors.

Section II of the NWCA educational program provides substantial information for general contractors to improve their knowledge and use of techniques for improving the management of their subcontractors and hence reducing their risks.

The first step in the subcontractor management process is the selection of subcontractors itself. By careful selection of subcontractors, including examination of some factors not usually included in the selection process used today, builders can take an important step at the outset of the process.

**This chapter covers the following:**

- 6.01 Traditional selection methods
- 6.02 Risks not considered by traditional selection methods
- 6.03 A new tool: using a subcontractor scorecard
- 6.04 Conclusions
- 6.05 Resources

## 6.01 Traditional selection methods



To some builders, the subject of selection of subcontractors is one that they consider to be fairly obvious. While many builders will cite a variety of factors in the selection of subs, ultimately much of the talk is simply lip service, and the bottom line is that one of two approaches is used (albeit with some minor modifications). And there is a third alternative that sometimes becomes a matter of necessity in some very high growth markets where the availability of some trades is difficult, to say the least.

**These three are:**

1. **Lowest price.** All other things being considered relatively equal at least at a cursory glance, some builders pick the lowest price, after setting aside any obviously “low ball” proposals. These contractors consider such factors as quality and reliability as “about the same” for subs warranting consideration or as factors that they (the generals) can control and/or enforce through actions such as delaying contract payments. The lowest price approach is particularly applicable in government contracts but often in commercial bids as well.

2. **Long-standing relationships.** Some builders develop an established system of suppliers and subcontractors based on their dependability in meeting the contractor's schedule, given at least some reasonable evidence that price is within reason and quality meets the contract specifications. Such contractors recognize the cost of delays in maintaining their schedules, and reward that sub with a steady flow of business. As long as the sub meets all of the contractor's demands for on-time performance and works immediately and successfully in solving any problems that may arise, these contractors rarely change their suppliers and subs, unless there is some major change, real or perceived, in the conditions affecting this relationship.
3. **Availability.** Particularly in markets with intense growth pressures, availability assumes an inordinate importance. For example, in one market there were so many houses being started that framers became an almost impossible commodity. Builders and/or their field superintendents were willing to take major risks in bringing in any framer that was available, at least for a trial, in order to meet production schedules. Another example is jobs where subs are typically paid local industry-established piecework rates and hence price is substantially reduced as a consideration.

## 6.02 Risks not considered by traditional selection methods



The new reality is that a growing minority of general contractors is recognizing that these traditional approaches (and any variations thereto) is gradually becoming increasingly ineffective because of a host of problems, including.

1. **Check and document general references.** Ironically, many general contractors will spend more time and effort checking out references for a low level employee than they will for a subcontractor responsible for a significant portion of a major job. This is true even though there are far more legal restrictions on what an employer is allowed to say about a former employee than there are on what one organization may say about another.

Increasingly, insurance companies and outside organizations specializing in protecting the general contractor clients are requiring a more thorough examination of all aspects of a proposed subcontractor's background and experience. That includes such "basics" as the following:

- **Trade references.** There is perhaps no better source of information than from other companies in the industry who have hired and/or worked with the particular subcontractor in question. Valuable insights can be obtained from such questions as, "what was your experience working with this sub, did they start/finish on schedule, how did they get along with other subs, how did they handle emergencies or extra requests, did they comply with state safety requirements, would you hire them again," and the like. Interviews with at least three such trade references can show a pattern emerging or raise flags that warrant either further examination or rejection of the sub in question.
- **Years in business.** Certainly in industries such as the construction industry, the number of years a subcontractor has been in business is a measure not only of its success in meeting the requirements of a variety of general contractors over the years, but also of the ability of its management to run a successful organization. One note of caution is the former employee of a subcontractor who forms a new business capitalizing on years of experience in the trade, but with little or no managerial experience. In such instances, the general contractor without adequate information on years in business runs the risk of suffering through the growing pains of an inexperienced manager.
- **Business license.** General contractors seldom take such elementary steps as obtaining a copy of the prospective subcontractor's business license. In these cases, the general may be liable not only for any fines imposed by the jurisdiction, but also for any damage or injury claims arising out of the subcontractor's work.
- **Association memberships.** Again, this is a rarely checked item, but it is a good indicator of the subcontractor's stability, longevity, and interest in betterment of his/her specific trade. Pertinent organizations include chambers of commerce; general industry associations such as local branches of the National Association of Home Builders; and trade specific organizations such as those for plumbers, electricians, sheet metal companies; and the like. Active participation in such organizations usually sends an even stronger message of the quality of the organization and its commitment to the community and to its specific industry. While not joining an association is not an automatic disqualifier, it does raise questions about the relationship of the subcontractor to the industry and the other organizations therein.
- **Bank references.** Another often overlooked source of information is the bank at which the general contractor does business, especially the loan officer assigned to that account. Obviously, loan officers have a vested interest in ensuring that their customers make sound decisions. They are a source of information on the financial strength and credit worthiness of potential subcontractors, both through published information and from observations made when such loan officers are verifying the status of completion in the field for their various loans.

2. **Factors not being checked.** More often than many people would expect, there are certain factors that contractors often neglect to check, especially the following:

- **Current license or registration.** For example, in Washington State one builders' association found that approximately 18 percent of its members were not registered and/or did not have a current registration. Yet all were continuing to be active in the trade since they appeared to be "members in good standing" of the association. A contractor who unknowingly hires an unregistered subcontractor may suffer several unintended consequences, including paying the much higher "payroll rate" for the sub's employees when audited or having no coverage at all for that sub's work.
- **Current insurance and/or bond.** Similarly, some contractors and subcontractors continue to operate even though their bonds and/or insurance policies have expired. A general contractor who fails to check the status of his/her subcontractor's insurance policy runs the risk of increased liability if an event occurs, such as a job-site injury to the unlicensed sub's employee.
- **Credit checks.** Many contractors do not take the time to run credit checks on prospective subcontractors. Yet, credit worthiness, or the lack thereof, is a good indicator of the subcontractor's ability to pay his/her bills. If the sub-contractor runs up a substantial bill with a supplier and fails to pay, either the general contractor or his/her customer may become liable for the unpaid amount.
- **Workers' comp issues.** Another neglected area is a review with the state construction licensing authority of the status of the subcontractor's bond, insurance, and history of claims. Without proper workers' comp coverage in place by the subcontractor, the general then becomes liable for that sub-contractor's employee who incurs a job-site injury or has some other time-loss event.

In many states, either the legislature or the applicable state department has increased the number of functional activities where general contractors are responsible for their sub's performance. Such changes increase the importance of checking records to determine whether the sub has a history of noncompliance. Some examples are:

- **Worker safety.** Increasingly, states have made the general contractor responsible for such activities as preparation of a written safety plan for the sub, onsite weekly safety meetings, and safe performance itself.
- **Working conditions.** A variety of rules requires the contractor to ensure the safety of working conditions, but some have even gone so far as the heat stress rule in Washington State, whereby the contractor is responsible for such things as providing specified amounts of water for regular consumption, scheduling work hours to allow worker adjustment to heat, de-misting stations for higher temperatures, and the like.
- **Civil and criminal histories.** Again, many contractors, in fact the majority do not check these records which may be of vital importance, particularly when sole

proprietorships are being considered. In one example, the contractor did take advantage of a local service available in some communities and discovered that the person whom he thought was best qualified for a particular job had a “rap sheet” of frightening proportions. General contractors may face serious legal issues if some incident occurred involving the subcontractor and the customer, particularly when that customer includes women, children, and the elderly. Not the least of these is the question of whether the general contractor exercised due diligence in checking out the history of the subcontractor.

**3. Expanding scope of legal liability.** When selecting a subcontractor, a general contractor should review the legal issues concerning Additional Insureds. This determines where the risks of construction lie in the state where the work is being performed. There is a current trend that appears to be increasing the general contractor’s liability and limiting that of the subcontractor accordingly. Several examples illustrate the point (see also the next two chapters in this section for more information on this subject). One such example is a case in which the contractor was held responsible for not only the performance or outcome, but also for the methodology used to achieve that performance and/or outcome. An often cited illustration of this is the case in California where a painting contract required that a specified thickness be achieved in two coats of paint. The painting subcontractor more than met the total millage requirement but did so in one coat. Under traditional approaches, many contractors would obviously have been pleased with the superior coverage and labor savings from applying one coat. However, the bottom line in this case was a major lawsuit lost by the general because his sub did not follow the precise methodology prescribed in the contract.

Another example is a new law in Colorado that precludes the use of primary, noncontributory additional insured language, and may further preclude the use of waiver of subrogation language as well. In plain English, this means that the general contractor cannot completely shift the risks of construction to the subcontractor. This law parallels one already in effect in California which has some of the highest liability insurance costs in the country, in part due to provisions such as the above. In this case, both the contractor and the subcontractor suffer higher insurance costs because the contractor has to first prove that the sub was at fault and the sub’s costs increase because of the need to defend himself. Typical primary, noncontributory contract language in other states precludes this added expense.

**4. Use of outside professionals.** Increasingly, local governments are requiring contractors to use outside professionals for a wide range of activities such as environmental analyses, traffic impacts, hydrologic surveys, soils analyses, stress calculations, and the like. Two practices by some local governments further complicate matters. One is that some local governments tend to accept the output of some professional organizations, but require a “second opinion” for others. A second is that some local governments “redline” (*i.e.*, change) the work of even registered engineers although the plans examiners in question do not possess the same professional credentials.

These outside professionals sometimes misunderstand the role and responsibilities of the subcontractor and attempt to dictate how the job will be done. Conversely, the subcontractor may be accustomed to working with other outside professionals and follow that experience and/or be experienced in reading plans and implementing them in accordance with their understanding of

the terms and conditions therein. In either case, the chances for miscommunication and error increases. The job of the general contractor in minimizing the risks is obviously increased in such cases where two subcontractors are working directly together.

In addition, the greater use of outside professionals poses two concerns. First, it increases the magnitude of the general contractor's job in selecting subcontractors. Second, it underscores the importance of taking greater care in making selection decisions in order to minimize the risks involved in managing those subcontractors, whether they are traditional trade people or outside professionals.

**In summary**, the four major factors discussed in the section above demonstrate that the old methods for selection of subcontractors and suppliers are becoming increasingly less adequate in today's construction climate. Contractors can do a better job of protecting themselves by using new techniques for selecting their subs. The following section of this chapter outlines a new potential tool for improving the process of selecting subs. While critics may claim that it takes more time, the reality is that the time required is far less expensive than paying for mistakes in subcontractor selection.

### 6.03 A new tool: use of a subcontractor scorecard



The NWCA has developed and field tested a new tool a subcontractor scorecard to help general contractors focus on the key elements of subcontractor backgrounds, operations, and performance. The scorecard is designed to be used after the general contractor has conducted an initial screening on the basis of price, delivery and availability, and eliminated those subs who are either not competitive or not able to meet schedules.

The scorecard requires contractors to address the issues raised in the preceding pages in this chapter without requiring an undue amount of time. It is clearly preferable to the lengthy questionnaires used by some insurers.

A sample of the scorecard is attached hereto as “Exhibit A.” The balance of this section covers:

- A general explanation of each major section of the scorecard
- A more detailed description of the specific factors to be evaluated
- The method of scoring and recommended decision ranges based on the total scores

The scorecard contains three major sections: basic category, specific factors, and scoring.

**Basic category.** This section lists three major areas of evaluation.

- **The first** major area of evaluation is General References, in which the emphasis is on obtaining information concerning the potential sub’s background, ethical reputation, performance, reliability, experience, current licenses and the like.
- **The second** is Third Party Data, which focuses on the sub’s overall financial strength, credit worthiness and industry performance.
- **The third** is Insurance Profile, which includes such issues as the status of the sub’s bond, evidence of a general liability policy and status of that policy.

**Specific factors.** The scorecard lists specific factors on which the potential sub is evaluated. They are:

- **Trade references.** A minimum of three references is required. The preferable sources for references are other general contractors and/or customers. In order to answer “yes” to the question on verification either written notes of the interview or a letter are required.
- **Years in business.** A minimum of three years is preferable, even if the sub has had extensive experience in this industry with some other company, as discussed earlier in this chapter. Sources for this type of information include the trade references as discussed above, trade associations, and/or state or local community license departments.
- **Business license.** In most states, contractors are either licensed or registered. In either case, the general contractor should obtain a copy of the state license to work as a contractor or subcontractor. This information, including the license number and the commencement and end dates, is generally available at the state’s contractor licensing authority. A source for the web-sites of these organizations is contained in the Resources section at the end of this chapter.
- **Association membership.** While a written letter may not be practical, at least a telephone call with an explanation of why the call is being made will illicit information on the subcontractor’s length of membership, level and extent of involvement, contributions to the organization, cost of membership, and the like.

- **Bank references.** To score points in this category, two bank references are required, one current and one previous. However, if the sub has only one very long-term bank reference (e.g., 10 years), that would serve as two because a relationship that long speaks for itself. Bank references serve two purposes: one is the current worth, credit worthiness, and prior history of the subcontractor; the other is as a source of information that may not otherwise be available to the general contractor. The most important of these is access to credit reports (see next factor).
- **Credit ratings, both business and personal.** Credit reports contain information on current and prior history, bankruptcies, outstanding accounts, and other information valuable in evaluating the potential subcontractor. The Resources section at the end of this chapter contains contact information on the three major credit reporting agencies.
- **Civil and criminal histories.** As the example discussed earlier in this chapter illustrated, a check of civil and criminal records can disclose information not necessarily available through other channels. Obviously, such information can have a major bearing on the decision to retain a subcontractor, especially in markets where the general is relatively new. Some areas of the country have local agencies that conduct such checks at a relatively modest cost. NWCA is currently working on developing further information on these resources.
- **Workers' compensation records.** Many states have some type of organization that maintains information on subcontractor licenses (or registration), bonding company and amount, insurance company and both outstanding and settled liens. Of particular importance is the overall workers' comp rating of the company, if available. An overall experience rating factor lower than 1.0 generally means that the company has a favorable claims rating, with payments into the system exceeding payments to injured workers during the year. Conversely, a rating greater than 1.0 generally means payments to injured workers exceed payment into the system by contractors or subcontractors. It may also make the contractor or subcontractor a candidate for reevaluation and higher rates. In some states the number of claims during the year is also a consideration in determining whether the experience rating factor remains the same or becomes less favorable.

General contractors should request a copy of the subcontractor's workers' comp records to verify its experience rating factor. In Washington, this information is available online from the state; in other states it may be available at other appropriate licensing authorities.

- **Bond.** General contractors should ensure that any potential sub has a current bond for a minimum amount of \$5,000. The minimum bond amount may vary from one state to another.
- **Certificate of liability insurance.** Plain certificates of insurance are readily available from the insured's retail insurance agent. They are used for a variety of

purposes. For example, organizations holding trade or home shows will often require Certificates of Insurance from every exhibitor.

- **Liability insurance coverage.** A specific requirement is assurance that the sub's liability coverage includes the type of work to be performed. For example, if the contract is for residential building, obviously the general needs to know that type of work is not excluded in the sub's liability policy. That information may be available in the Comments Section of the Certificate of Insurance; otherwise it will be necessary to review a copy of the potential sub's own liability policy.

**Scoring.** Following the guidelines outlined above, each question should be marked either in the "Yes" or "No" column.

The Total at the bottom is the number of "Yes" votes received. Since there are 13 factors, the highest possible total score is 13. NWCA field tests show that a score of 10-13 is very good and the potential sub is highly acceptable; 7-9 is marginally acceptable, especially if there are any special mitigating circumstances; and 7 or below is not acceptable for further consideration as a subcontractor for the particular job under consideration.

However, these scoring ranges are guidelines and may indicate areas where corrective or additional action is required. For example, if there are negative scores in the insurance portion of the scorecard, policy changes may be taken to change the answers and hence the score.

## 6.04 Conclusion



The growing costs and complexities of both the construction and insurance industries has made it imperative that contractors take every possible step to reduce the risk of being involved in construction defect litigation. One of the emerging areas for reducing this risk is by doing a better job of managing subcontractors, particularly since there are growing pressures and specific actual steps being taken to place greater responsibility on the general contractor for the functions and activities of that general's subcontractors.

As discussed in this chapter, the traditional methods of hiring subs are becoming increasingly less adequate to provide the general with the information and protection needed in the selection process. The NWCA has developed a scorecard for use by general contractors as a guide in improving their processes for hiring subs and thereby reducing their risks at the outset of a new construction project, either commercial or residential. This chapter provides a full explanation of what is contained in the scorecard and how to use it.

The insurance carriers included in the NWCA program have all indicated that one of the major reasons they have offered special rates and conditions to NWCA members in their agreements with Flying Eagle Insurance Services (FEIS) is the existence of innovative techniques such as this scorecard and other educational programs included in the NWCA's members-only Learning Center.

Thus, successful incorporation of the NWCA subcontractor scorecard is another important element in reducing contractor and subcontractor risks and thereby obtaining lower insurance costs from FEIS.

## 6.05 Resources



Some of the sources for additional information on the subjects in this chapter are:

The three credit reporting agencies are:

1. **Equifax:** P.O. Box 740241, Atlanta, GA 30374; 800-685-1111  
[www.equifax.com](http://www.equifax.com)
2. **Experian:** P.O. Box 2002, Allen, TX 75018; 888-397-3742  
[www.experian.com](http://www.experian.com)
3. **Transunion:** P.O. Box 1000, Atlanta, GA 30374; 800-916-8800  
[www.transunion.com](http://www.transunion.com)

For information on workers' comp subjects in all states **except** Washington, contact:  
<https://www.ncci.com/ncci/index.aspx>.

In Washington, contact:  
<https://fortress.wa.gov/lni/crpsi/MainMenu.aspx>

For specific information on workers' comp programs and assistance in reducing workers' comp costs, contact NWCA vendor member, Work Comp Advisors, by mail at:

9985 Glacier Ridge Drive, Sandy, UT 84092

By telephone at 801-699-0418, by fax at 801-303-7368 or by email at:  
[chris@workcompadvisors.net](mailto:chris@workcompadvisors.net)

## Exhibit A:

### SUBCONTRACTOR SCORECARD

Basic Category	Specific Factors	Yes	No
General References	<b>Trade References</b>		
	Are there 3 or more favorite references?		
	Are the favorable references verifiable?		
	<b>Years in Business</b>		
	Have they been in business 3 or more years?		
	<b>Business License</b>		
	Do you have a copy of their license?		
Third Party Data	<b>Association Membership</b>		
	Are they a member of a business or trade association?		
	<b>Bank References (2 Minimum)</b>		
	Do they have 2 favorable bank references?		
	<b>Credit Ratings (Personal / Business)</b>		
	Is their business credit rating above 600?		
	Is their personal credit rating above 630?		
Insurance Profile	<b>Civil, Criminal History</b>		
	Does the Principle / Owner have a civil / criminal record?		
	<b>Workers' Compensation Records</b>		
	Is their experience rating factor / modification < 1.0?		
	<b>Bond</b>		
	Do they have a company bond of at least \$5000.00?		
Insurance Profile	<b>Certificate of Liability Insurance</b>		
	Is the General Contractor named on the certificate?		
	<b>Liability Insurance Coverage</b>		
	Is the insurance current and pertain to the type of work?		

(1 Point for every "Yes" answer)

TOTAL