Effective Contractual Risk Transfer in Construction

CONSTRUCTION RISK MANAGER

Effective Contractual Risk Transfer in Construction[1]

By Ann Rudd Hickman

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This white paper provides a concise overview of strategies for improving the contractual risk transfer process from the point of view of both the risk transferor and the risk transferee. Both legal and insurance issues are addressed.

Strategies for Transferring Risk to Others

Hiring (upstream) parties usually have greater bargaining power in transferring certain project risks to downstream parties. However, onerous provisions that provide little or no benefit, require coverages that are difficult or impossible to obtain, or unnecessarily increase the cost and time of completing the project benefit no one. By drafting contract language that is current, compliant with applicable statutes, and consistent with insurance industry methods of providing coverage, indemnitees can obtain reliable protection and avoid unnecessary costs and frustrations. This paper provides strategies for achieving these goals.

About the Author

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[1]This special report is based on and includes excerpts from "Contractual Risk Transfer Tips," an article in *Construction Risk Management*, Copyright 2014, IRMI.

Observe Statutory and Common Law Limitations

Most states impose limitations on the types of risk that can be transferred to another party in construction and/or design contracts. For example, some states prohibit the transfer of one's own negligence to another party (broad and intermediate form indemnity); others prohibit only the transfer of one's *sole* negligence (broad form indemnity). Likewise, the transfer of "gross negligence" or of punitive damages has been deemed to be against public policy in some jurisdictions.

Case law may also impose limitations on the enforceability of certain risk transfers. For example, even in states that allow broad form indemnity, courts may require "clear and unequivocal" language that demonstrates that both parties understood what was being transferred and knowingly accepted the transfer. Some courts are even more stringent regarding transferring liability for one's own negligence, requiring the specific use of the word "negligence" conspicuously placed in the contract. Together, these requirements are known as "fair notice requirements."

TIPS FOR TRANSFERRING RISK TO OTHERS

DO ...	DON'T ...
✓ Have knowledgeable counsel draft indemnification clauses that conform to statutory and common law limitations. ✓ Support indemnity provisions with insurance requirements. ✓ Require additional insured status on indemnitors' CGL policies; if possible, get a copy of the endorsement used to provide this coverage. ✓ Request, review, and maintain copies of all certificates of insurance. ✓ Keep requirements reasonable. ✓ Allow for flexibility. ✓ Update insurance requirements regularly. ✓ Verify ongoing compliance with insurance requirements. ✓ Be prepared to pay more when you require the other party to accept more risk.	✓ Invalidate risk transfers by exceeding the permissible level of risk transfer. ✓ Require additional *named* insured status. ✓ Ask for coverages you can't give a valid and specific purpose for requiring. ✓ Expect the other party to rearrange its negotiated annual insurance program to meet your needs. ✓ Copy insurance requirements from old contracts without having them reviewed by a knowledgeable insurance professional. ✓ Copy indemnity clauses from old contracts, or contracts used in states other than the project's state, without having them reviewed by a knowledgeable attorney in the project state. ✓ Demand copies of all policies or make unreasonable demands of indemnitors' insurance providers.

The risk to an indemnitee seeking protection via an indemnity clause that exceeds the legal boundaries is that it will end up with no protection for claims within the allowable limits, since the entire clause may be void. The best way to ensure the enforceability of an indemnity provision is to have knowledgeable legal counsel develop indemnity clauses that conform to the applicable statutes and common law requirements. As a backup, the use of a savings clause, which incorporates the phrase "to the extent permitted by law" into the indemnity provision, may be effective in preserving indemnity obligations that are allowed under the applicable statute.

Support Indemnity Provisions with Insurance Requirements

Indemnity agreements and other risk transfer techniques are only as good as the indemnitor's ability to meet its contractual obligation to indemnify. In most cases, an indemnification obligation is grounded in the indemnitee's liability to a third party who is a stranger to the contract. An indemnitee is not absolved of any liability solely by the presence of an indemnification agreement. Consequently, prudent indemnitees will take reasonable steps to ensure the indemnitor's ability to fund these obligations if a loss occurs.

Reviewing an indemnitor's financial records is both infeasible and impractical. Not only would most companies object to granting access to such private information, but the cost of obtaining and analyzing the financial statements of several hundred to several thousand indemnitors' records (on an ongoing basis) would be prohibitive. As a result, assurance of the ability to pay is usually obtained by requiring indemnitors to carry insurance that will respond to their contractual obligations. Unless endorsed otherwise, both the standard Insurance Services Office, Inc. (ISO), commercial general liabil-

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Learn where standard insurance programs have unique implications for contractors.

Stay on top of emerging strategies for managing construction risks.

Explore the Benefits

ity (CGL) policy and business auto policy (BAP) automatically provide coverage for bodily injury or property damage liability of others assumed by the insured in an "insured contract." While some exceptions apply, most ordinary indemnity obligations for liability to third parties assumed in a construction contract would be covered.

The question of how much coverage to require is more difficult to answer. The proper limits to require will vary based on the size of the project, the nature of the project, and the specific construction trade. For example, higher limits would likely be required for power plant and high-rise construction than for construction of a strip mall. Likewise, higher minimum limits will likely apply to a blasting contractor than a landscape contractor. Many construction contracts require a designated project limit, which ensures that an amount equal to the full policy limit will be available for claims arising out of the project. This avoids the possibility of the policy's limits being eroded or exhausted by claims from other projects. Designated limits apply only to the premises and operations coverage (i.e., not to the completed operations coverage) and are provided by endorsement to the CGL policy.

Additional Insured Requirements

When an indemnity provision exceeds what is allowed by law or does not satisfy the "clear and unequivocal" threshold, a court may declare all or part of the provision unenforceable. In that case, the would-be indemnitor's legal obligation to indemnify is erased, and its contractual liability insurance coverage is not triggered. In that case, if the indemnitor were to provide the promised indemnification, it would have to pay out of its own pocket and not with insurance money. The lack of certainty regarding the enforceability of indemnity provisions presents a serious risk that indemnitees will be stuck with losses they thought had been transferred to someone else.

While indemnitees should not expect to transfer more risk than the law allows, they do want to avoid inadvertent failures to properly execute risk transfers that are fairly negotiated within the boundaries of the law. Toward that goal, indemnitees usually require that they be made additional insureds under their indemnitors' liability policies. As insureds, they have direct access to the insurer and are entitled to a defense of potentially covered claims and coverage for insured losses. Because additional insured coverage is not dependent upon the enforceability of the indemnity provision, it provides a sound "backup" to the indemnity provision. Some refer to this strategy as a "belt and suspenders" approach.

Standard endorsements are available for providing additional insured status under the CGL to various types of entities, such as project owners, lessors, vendors, contractors, and design professionals. Not all endorsements are created equal, so where multiple versions are available, be careful to determine which is the appropriate endorsement for the situation. For project owners and upstream contractors, ISO endorsements CG 20 10 (for ongoing operations) and CG 20 37 (for completed operations) extend coverage to the additional insured for liability caused in whole or in

part by an act or omission of the named insured in its performance of work for the additional insured. Except where prohibited by law, these endorsements provide a scope of coverage comparable to the obligation that would be owed under an intermediate form indemnity agreement. (Where state laws forbid the providing of additional insured coverage that exceeds the allowable level of indemnity, and the allowable indemnity is limited to the indemnitor's negligence, that is the coverage provided to the additional insured.).

Tips for Requiring Additional Insured Status. Requesting additional insured status on an indemnitor's policies is coverage is a common "backup" strategy for ensuring the funding of the indemnitor's contractually assumed liabilities. However, it is also the source of significant misunderstanding and coverage disputes. Care must be taken to make sure the coverage you get is consistent with what is expected and intended in the underlying contract. Following certain tips for requiring additional insured status can help accomplish that objective.

TIPS FOR REQUIRING ADDITIONAL INSURED STATUS	
DO ...	**DON'T ...**
✓ Require coverage equivalent to that provided in the appropriate standard endorsement. ✓ Require a copy of the endorsement used to provide additional insured status—or, if not available, require that the certificate of insurance specify the additional insured endorsement form utilized. ✓ Check the "other insurance" provisions of your own policies to see how they respond when other coverage is available to you as an additional insured. If necessary, endorse your policy to provide excess coverage in that scenario. ✓ Require additional status under primary and excess layers of the indemnitor's liability policies. ✓ Require additional insured coverage of "at least" the specified policy limits.	✓ Require indemnitors to provide older versions of standard endorsements that are no longer available to most contractors or to attach a manuscript endorsement drafted by your legal counsel. ✓ Require additional *named* insured status. ✓ Agree to provide reciprocal or mutual additional insured status. ✓ Require coverage that exceeds statutory limitations on additional insured requirements. ✓ Require additional insured status on an indemnitor's auto policy. ✓ Require additional insured status on an indemnitor's workers compensation policy. ✓ Require additional insured status on a professional liability policy. ✓ Accept "additional insured" status in another party's "self-insurance program."

Problems with Additional Insured Status

Use of Nonstandard Additional Insured Endorsements. Where allowed by law, current editions of the standard ISO additional insured endorsements provide coverage that is comparable to the obligation that would be owed by the named insured (indemnitor) under an intermediate form indemnity agreement. Because ISO represents its member insurance companies, these endorsements reflect the general position of the insurance industry regarding the coverage it is willing to provide to additional insureds. Although some large contractors with significant bargaining power may be able to persuade their underwriter to attach older versions of these endorsements (which provided significantly broader coverage), many contractors will not be able to comply with requirements that they provide the coverage that was available under prior editions of the endorsement, most notably the 11/85 edition of CG 20 10.

Likewise, underwriters do not like to attach manuscript additional insured endorsements drafted by other parties (who are not even their customer), and most have strict rules against doing so. Not only are these endorsements not tested by the courts (so there is no way of knowing how they might be interpreted), but they virtually always include broad coverage terms and/or additional obligations for the insurer. As a result, requiring a manuscript endorsement should only be considered under very unique circumstances and only with an understanding that it will involve extra time and money to negotiate, if it can be done at all.

The use of nonstandard additional insured endorsements has become common, and the scope of coverage they provide varies significantly. Some include a variety of significant coverage restrictions such as residential construction exclusions or broadened limitations on coverage for the additional insured's own negligence, including defense costs. The only way to know exactly what coverage you are getting as an additional insured is to require a copy of the endorsement. However, unless you establish a process for reviewing these endorsements to determine if they are acceptable, this extra requirement will increase the administrative cost of obtaining compliance but not necessarily result in better coverage.

Priority of Coverage Disputes. Unfortunately, additional insured coverage can create coverage disputes between insurers. When a claim for damages is filed against an upstream party on a construction project, multiple policies are usually triggered. For

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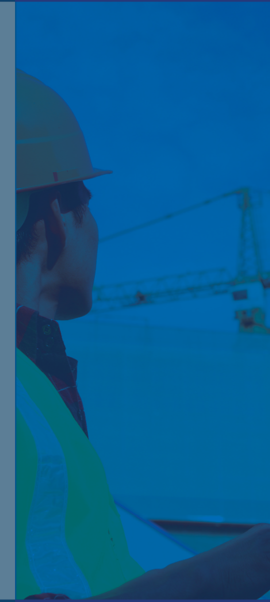


example, if a claim is filed against a project owner by the owner of adjacent property for damage caused by the contractor working on the project, both the owner's own CGL policy and the contractor's policy on which the owner is an additional insured will be triggered for that claim. In almost all instances, it is the intention of the upstream party that the policy on which it is an additional insured will respond first to the claim. Arranging the priority of coverages to achieve this result—with additional insured coverage as primary and noncontributory (i.e., not seeking contribution from other primary insurance)—has been an ongoing challenge for additional insureds.

The ISO CGL policy already achieves the desired outcome (if both policies use standard "other insurance" language) even though the phrase "primary and noncontributory" does not appear in the provision. Rather, the standard CGL policy provides that it is primary coverage, except under a few circumstances. The policy becomes excess when the named insured has other primary coverage for a claim as an additional insured on another policy. When both policies have standard language, the interplay between the two policies is clear—the policy on which you are an additional insured is primary and your own policy is excess. This is usually consistent with the intentions of both the named insured and the additional insured, and with the contractual allocation of liability. Nevertheless, upstream parties often want to see the "primary and noncontributory" language. ISO endorsement CG 20 01 stipulates that the policy is primary over other policies on which the additional insured is a named insured when there is a written contract or agreement in which the named insured contractor agrees to provide primary and noncontributory coverage.

When nonstandard policies or endorsements are in play, however, nonstandard "Other Insurance" conditions may apply that reduce the effectiveness of the risk transfer.

Insurers are usually willing to provide additional insured coverage on both a primary basis (meaning it will be in the first tier of policies responding to a covered loss) and on a noncontributing basis (meaning it will not attempt to force other primary coverage—such as the additional insured's own policy—to share the loss). A standard primary and noncontributory endorsement is available.

Further, if your own policy does not contain an excess provision with respect to additional insured coverage, a sharing of the loss is still possible. The best approach, therefore, is to first make sure the intent for the indemnitor's policy to apply on a primary basis is clear in the underlying construction contract and then ensure your own CGL policy says it is excess over any other coverage available to you as an additional insured.

Avoid Certain Requests. Other stipulations to avoid in additional insured requirements include requiring that you be made an additional *named* insured, requiring mutual additional insured status on each other's policies, and requiring a cross liability endorsement. A handful of states also prohibit requiring additional insured coverage that exceeds the allowable scope of indemnity.

The OCP Alternative. Because of the problems inherent in additional named insured status, some indemnitees prefer to be covered for their vicarious liability arising out of a construction project by an owners and contractors protective (OCP) liability policy. The standard ISO OCP policy provides direct coverage for the indemnitee, as the named insured, for liability arising out of an act or omission of the designated contractor in connection with its operations for the named insured as well as for the named insured's negligence in its general supervision of such operations. The indemnitee has the full limit of insurance, without fear of erosion from claims arising out of other projects. The policy states that it is primary and that the insurer will not seek contribution from the other insurers. However, the OCP policy also has some major shortcomings. Most notably, its scope of coverage is not as broad as that provided under standard additional insured endorsements; there is no option for completed operations coverage; and it does not provide access to the indemnitor's umbrella policy.

Keep Requirements Reasonable

Because the construction industry is highly competitive, the hiring (upstream) party usually has the stronger bargaining position and can apply its leverage to the negotiation of the indemnity and insurance provisions. Sometimes these organizations take an "ask for the moon" approach to contractual risk transfer in an attempt to cover all possible bases. Nothing is gained by requiring $50 million in liability coverage from all trade subcontractors when few, if any, are going to be able to comply. Unfortunately, requests for unnecessary or duplicative coverages and unrealistic limits are quite common.

It is not always in a party's best interest to impose onerous risk transfers and insurance requirements just because it can. This type of strategy fosters an adversarial relationship between the contracting parties, com-

plicates the contracting process, and increases the cost of construction. Further, the time and effort spent achieving compliance (or granting exceptions) may be disproportionate to the protection gained by overreaching requirements.

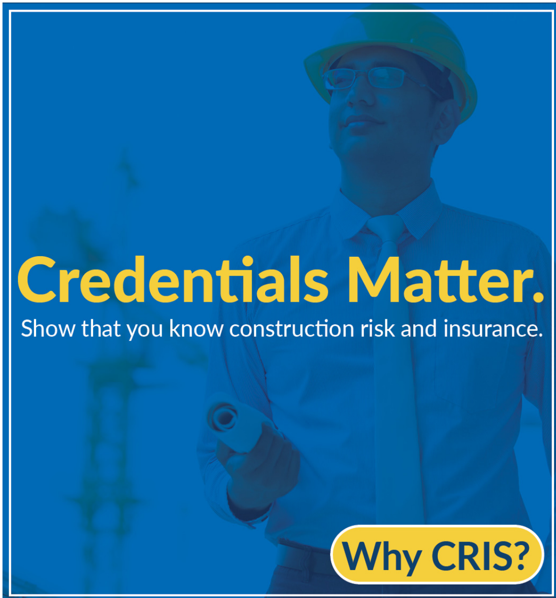
A better approach is to determine what level of risk transfer and supporting insurance requirements will provide an acceptable degree of protection without unnecessary redundancies. Seek input as to what are reasonable limits and coverages to require of contractors and subcontractors based on market realities. This approach generally results in a smoother contracting process, a more unified construction team, and a better overall project experience.

An example of overkill is demanding both additional insured status *and* an OCP policy. These two coverage options provide comparable coverage, and requiring both accomplishes little more than increasing the cost of the work. Similarly, requiring additional insured status on indemnitors' professional liability is unrealistic because most insurers will not agree to this request. In fact, in most cases being an additional insured would be detrimental to the indemnitee because professional liability policies usually contain "insured versus insured" exclusions. Being an additional insured may prevent coverage when the indemnitee files a professional liability claim against the indemnitor, which is the primary reason you want them to have the coverage in the first place. For example, if a project owner demands additional insured status on a contractor's professional liability policy, a claim by the project owner against the contractor for a design error may not be covered due to the exclusion of claims filed by one insured against another insured.

Allow for a Reasonable Amount of Flexibility

Equity issues aside, indemnitees should attempt to structure their risk transfers and supporting insurance requirements to obtain the needed protection with minimal disruptions to their own insurance programs, as well as those of their indemnitors. Most contractors buy insurance on a blanket annual basis, rather than project-by-project, to apply to all of their projects. A significant amount of shopping and negotiation is involved in arranging an efficient and effective insurance program. Overly stringent insurance requirements that require indemnitors to change the structure and terms of a carefully negotiated program may result in extra costs that will likely be passed on to the indemnitee.

Suppose the owner of a construction project specifies that the contractor must purchase a CGL insurance policy with a $2 million limit of liability. Technically, a contractor with a $1 million CGL policy and a $10 million excess policy would not be able to meet this requirement, even though it has more than the required limits in its overall liability program. If the appropriate "other insurance" language is in place, the additional insured would have adequate protection under either arrangement. (An exception to this rule of thumb might be where a state requires horizontal exhaustion of all primary policies before any excess policies are triggered. In that case, the difference in the contractor's primary limit could impact the additional insured's coverage.)



Keep Requirements Up-To-Date

Requirements that refer to insurance policies and endorsements by name or by number can quickly become outdated. Unfortunately, the attorneys drafting the contracts often lack specific knowledge of insurance coverages and insurance market conditions. As a result, they sometimes request modifications that are unnecessary, are impossible to obtain, or result in unnecessary additional expense.

For example, although the commercial general liability (CGL) policy replaced the *comprehensive* general liability policy in the mid-1980s, some contracts still require "comprehensive general liability insurance." Along with that, these contracts may also require a number of endorsements that were needed on the old form but were incorporated as standard coverages in the commercial general liability policy. Requiring endorsements for contractual liability, broad form property damage, or cross liability coverage, for example, are unnecessary because they are included in the standard policy. A stipulation that these coverages be included in the policy is appropriate, but not that they be added by endorsement.

Requirements that are out-of-date and out-of-sync with the market not only make compliance difficult (in some cases technically impossible), they create unnecessary friction and confusion in the contracting process. Inaccurate contract terms can also lead to litigation amongst the parties. Therefore, contract insurance requirements should be reviewed periodically by a knowledgeable insurance professional (usually the risk manager or insurance agent or broker) for outdated terminology and other practical issues that call for modifications.

Verify Compliance with Insurance Requirements

Although most indemnitees require indemnitors to provide evidence that the required coverages are in place when the contract is executed, many do not monitor compliance with this requirement. While an indemnitor's obligation to indemnify is independent of its insurance coverage, in many cases, inadequate insurance will substantially impair the indemnitor's ability to meet its contractual obligation. Because the underlying coverages are the backbone of the risk transfer, indemnitees should take reasonable steps to confirm that the required coverages are in place.

The most common method of obtaining evidence of insurance coverages is to require the indemnitor to provide a certificate of liability insurance. The most commonly

used certificates of insurance are the standard ACORD forms. A completed ACORD certificate provides the names of the insurers providing the required coverages, policy numbers, effective dates, expiration dates, and applicable limits of liability. The certificate includes a column for noting whether the certificate holder is an additional insured under each listed policy and a box for listing any exclusions added by endorsement and other "special items." The additional insured endorsement number may be noted here, among other things.

Shortcomings of Certificates of Insurance

The two most significant complaints regarding standard certificates of insurance are (1) that the certificate holder is not guaranteed notice of cancellation of the designated coverages and (2) that the certificate contains numerous disclaimers indicating that the information on the certificate is not binding on the insurers. A certificate holder's reliance on a certificate that contains false information may result in less coverage than expected. Some of these problems have limited remedies; others do not.

Notice of Cancellation. Current versions of the standard ACORD certificates state that notice of cancellation will be "delivered in accordance with the policy provisions." Standard form policies would not require notice of cancellation to an additional insured. In order to obtain notice, the construction contract must specify that the policies be endorsed to guarantee notice of cancellation to the additional insured (which should match the certificate holder). The right to notice of cancellation can be effected by modifying the additional insured endorsement or by separate endorsement. Some insurers resist this request; others will grant it.

Disclaimers. One of the most frequently encountered problems with certificates of insurance occurs when the coverage represented in the certificate does not match that of the actual policy. For example, the certificate may indicate the certificate holder is an additional insured under the indemnitor's liability policy when in reality this modification was never made. Or the policy may contain additional exclusions that significantly reduce the scope of coverage, such as a residential construction exclusion, that are not listed on the certificate. Unfortunately, this problem is usually not discovered until it is too late, i.e., after a loss has occurred.

The standard ACORD form contains elaborate disclaimers stating that the information provided on the certificate does not alter the terms of the policies it describes. Courts have fairly consistently held that disclaimers of this sort are valid, and the provisions of the insurance policy supersede the information provided on the certificate. Although some challenges to this position have been successful, fighting for coverage through the courts is not what anyone wants or expects when drafting the risk transfer provisions.

Some indemnitees attempt to avoid unexpected surprises by requiring copies of all policies, but this is not always a feasible or desirable solution. Many times it is difficult to obtain complete copies of the policies in a timely manner. Further, an unexpected con-

sequence of obtaining copies of all of the policies is that the indemnitee may then be estopped from later claiming that the coverage provided by the policy did not conform to its requirements.[2] Therefore, every policy would have to be reviewed and determined to be in compliance, which requires an understanding of insurance coverages that goes well beyond the level of most clerks, who are usually assigned the job of managing certificates. Assigning qualified insurance professionals to perform this task is expensive if more than a nominal number of reviews are required in a given year.

Manuscript Certificates. Some indemnitees consider the standard certificate too limited for their purposes. To correct these "deficiencies," indemnitees sometimes develop their own customized, or manuscript, certificates that they require indemnitees to have completed by their insurance representatives. In addition to the information sought by the ACORD certificate, manuscript endorsements typically require more detailed information, such as deductible levels, paid or pending claims that reduce the amount of available coverage, and A.M. Best's rating of listed insurers. Manuscript certificates virtually always stipulate that the certificate holder will be notified if a policy is canceled or nonrenewed and contain no disclaimers regarding the information contained in the certificate. Indeed, it is more likely that the certificate will include a statement that the information is a legally binding representation of coverage. While manuscript certificates may sound like a solution to the limitations of standard certificates, most insurance companies (as well as agents and brokers) are reluctant to sign them and many refuse to do so. Additionally, using them violates insurance regulations in a number of states. Because they present such difficulties, manuscript certificates are not commonly used.

[2]Some courts have held that failure to require evidence of required insurance coverages or to require a new certificate when the original did not conform to the indemnitee's requirements constitutes a waiver of such requirements. It is likely that these courts would find similarly against an indemnitee who has a copy of a noncompliant policy and does not take action to either obtain compliance or terminate the contract within a reasonable time.

Certificate Management

Despite their limitations as legal documents, certificates can be an extremely valuable source of information when a claim arises, especially claims filed long after the project is completed. The key is being able to locate the applicable certificate when it is needed. Indemnitees should establish an organized certificate management system to monitor compliance with insurance requirements and serve as a permanent record of coverages.

Effective certificate management involves verifying that certificates are received, that they are properly completed and signed, and that the description of coverage conforms to the applicable insurance requirements. If a certificate does not include one or more of the indemnitee's requirements, a replacement should be requested with the appropriate changes. Over the course of the project, as the expiration date of any policy listed on a certificate approaches, a new certificate should be requested and verified for compliance.

Automated certificate management programs that support most of these functions are available from several vendors, and most of the web-based applications offer complete tracking services for a fee. If the number of certificates a contractor receives does not justify the cost of an automated system, even a basic manual system can be an effective monitoring technique if it is performed diligently. Digital images of certificates should be maintained indefinitely. (Pollution and asbestos claims are still being filed on policies issued in the 1960s and 1970s.)

Expect To Pay for Risk Transfers

Indemnitees sometimes erroneously view risk transfers as "free insurance." Since indemnitors can reasonably expect higher losses under a broad form indemnity agreement, which will result in higher current or future (depending on the rating program) insurance premiums, they often charge higher insurance costs for contracts requiring broader indemnities. Likewise, any additional premiums incurred to secure required nonstandard coverages likely will be passed back to the indemnitee. Further, the most stringent insurance requirements increase the likelihood that the requirements will not be complied with or compliance will be feigned. Thus, seeking the highest level of protection may result in no protection at all despite the considerable effort expended to obtain it.

Strategies for Accepting Risk from Others

Although parties transferring risk (i.e., indemnitees) generally have the better bargaining position, those accepting such risk transfers (hereafter "indemnitors") need not adopt an attitude of helplessness. By developing a strategy for dealing with contractual risk transfers, indemnitors can often reduce the amount of risk they assume and avoid cumbersome or unreasonable insurance requirements.

Read the Entire Contract

During contract negotiations, the parties involved generally are focused on cutting the deal, not on the insurance requirements. In fact, in many instances the insurance requirements are simply lifted from prior contracts and pasted into the document at hand with little or no modification, a sort of "one-size-fits-all" approach. The risk manager (or other person responsible for procuring insurance) may not even see the contract until after it is signed. Thus, the first step for controlling the assumption of risks is to establish a process for performing a risk management review of contracts, *before* they are signed, to identify potential risk and insurance problems.

Although risks can be transferred in virtually any provision of a contract, in many cases the person performing the risk management review is provided only with the provisions dealing with indemnity and the insurance requirements. Limiting the review to these sections of the contract can obscure significant risks presented in other contract provisions. Further, indemnity provisions, limitation of liability, and other risk allocations may appear in parts of the contract other than those labeled as such. For example, indemnification associated with the discovery of hazardous materials at the

jobsite is usually addressed in a section of the contract that is outside of the general indemnity agreement.

If the company has a risk management staff, someone in that department with knowledge of both risk transfer and insurance issues is a logical person to perform these reviews. In a smaller organization, the CFO is often assigned this responsibility. The insurance agent or broker should be consulted as needed to verify coverages. (Many agents will answer specific coverage questions but will not formally declare the contractor's program as compliant out of concern of a potential errors and omissions claim.)

Negotiate for Better Terms

Although indemnitees typically have the stronger bargaining position, indemnitors should take an active role in negotiating contract terms that are reasonable and workable in their insurance programs. Offer reasonable alternatives that provide compa-

TIPS FOR ACCEPTING RISK FROM OTHERS	
DO ...	**DON'T ...**
✓ Read the entire contract. ✓ Negotiate for reasonable changes in risk allocation provisions. ✓ Try to negotiate a cap on indemnity and additional insured coverage. ✓ Follow through on agreements to provide additional insured status to indemnitees, including through the required period of completed operations coverage. ✓ Consider adding blanket additional insured endorsements to your CGL policy. Make sure coverage attaches only in connection with your operations for the additional insured. (Multiple endorsements may be needed to ensure additional insured status for all required parties, including design professionals.) ✓ Consider all indemnification obligations when selecting limits for your liability insurance program.	✓ Negate a carefully negotiated indemnity provision by providing additional insured coverage that exceeds the indemnification requirements. ✓ Cap the limit of coverage available to an additional insured unless you also cap the indemnity. ✓ Agree to waive subrogation if your policies do not give you the right to do so. ✓ Agree to add another party as an additional insured on your workers compensation or professional liability policies. ✓ Agree to make changes in your insurance program, or to use manuscript endorsements or certificates, before discussing with your underwriter.

rable coverage and are more compatible with the contractor's annual insurance program. Also, take the opportunity to educate indemnitors whose requirements include unnecessary or redundant coverages, out-of-date insurance terminology, or coverages that are simply not available in the current marketplace (or available only at a significant extra cost). Indemnitees are sometimes willing to make reasonable changes in their requirements to reduce conflicts or to improve the contracting process, as long as they still receive adequate protection.

Contractors should go to the contract negotiations armed with guidelines that specify their preferred, acceptable, and unacceptable positions on common risk transfer provisions for the type of contract being executed. (These positions will vary based on the type and location of the project.) These guidelines serve as a tool by which the party negotiating the contract can determine what to ask for, what to accept, and when to walk away from the contract altogether.

Cap Liability and Indemnity

A limitation of liability clause serves to limit the indemnitor's liability to the other party to a specified amount, such as the contract value, the amount of insurance required in the contract, or some other amount agreed upon by both parties. Whether the source of the liability is based in tort law or contract law, contracting parties are permitted to negotiate a limit on one or both parties' liability to the other party. (Contractual limitations typically do not extend to liability to parties outside the contract.) For example, design professionals often try to limit their liability for design errors to the fee they receive for their services under the contract and are often successful in their efforts.

Most indemnity clauses are open-ended, meaning there is no upper limit on the indemnitor's contractual liability to the indemnitee for liability that falls within the scope of the indemnification agreement. Indemnitors can negotiate for a reasonable cap on the indemnity obligation, such as the amount of insurance required in the contract. Of course, indemnitors often lack the bargaining power to negotiate these types of limitations.

If a limitation on all forms of liability is unobtainable, it may be possible to obtain limitations on certain types of risks. For example, a contractor with a relatively small contract to perform maintenance work for a very large plant may be able to negotiate either a cap on its liability for damage to the plant and/or a waiver of subrogation with respect to existing property. This is a reasonable request given the contractor's scope of work, and many property owners will agree to such a limitation.

To confidently rely on limitation of liability clauses, care must be taken to assure that the clause is valid and enforceable and that it complies with all statutory requirements and safeguards.[3] In keeping with general principles of contract law, any ambiguities in the clause will be construed strictly against the party drafting it.

[3]A handful of states have statutes addressing the enforceability of limitation of liability clauses in construction or design contracts.

Match Additional Insured Coverage to Indemnification Obligation

Additional insured status and indemnity obligations operate independently of each other. For example, if the indemnity obligation applies only to liability arising out of the named insured's negligence, no coverage would apply under the indemnitor's CGL contractual liability coverage for that portion of any claim that is attributable to the indemnitee's negligence. However, a claim against an additional insured is governed not by the underlying construction contract but by the insurance policy provisions. So if that same indemnitee is also an additional insured under a standard additional insured endorsement, coverage is available to that additional insured not just for liability attributable to its own negligence, but also liability caused by the indemnitor's contributory negligence. In other words, the scope of additional insured coverage exceeds the contractual indemnification obligation. Some older versions of the standard additional insured endorsements even include coverage for the sole negligence of the additional insured.

The request for additional insured status is so common that many organizations routinely comply without giving any thought to the extent of coverage they are giving away. Many contractors and subcontractors put forth great efforts to negotiate a limited indemnity agreement (i.e., the obligation to indemnify is limited to damages caused by the indemnitor's own negligence) only to turn around and grant the indemnitee additional insured coverage that equates to intermediate form indemnity. If the scope of coverage under the additional insured endorsement exceeds the indemnification obligation, all the work that went into the contract negotiation is negated.

The current editions of the standard ISO additional insured endorsements provide coverage comparable to intermediate form indemnity, except where such coverage violates state law. In states that allow only limited form indemnity (indemnity for the indemnitor's negligence) *and* prohibit providing additional insured coverage for liability that cannot legally be transferred in an indemnity agreement, the standard endorsement provides only the coverage that is permitted by law. This language will not restrict coverage in states where intermediate form indemnity is permitted or in states where anti-indemnity provisions do not apply to additional insured coverage. In those states, contractors who successfully negotiate limited form indemnity agreements would need to negotiate additional insured language with their insurer that restricts the additional insured's coverage to liability for the named insured's negligent acts or omissions. To avoid contract disputes, any limitations imposed on the scope of coverage provided to an additional insured (beyond those incorporated in the standard endorsements) should be clearly communicated to the indemnitee, preferably in writing.

Resist Manuscript Forms

Indemnitees sometimes attempt to dictate the language of the additional insured endorsement either by requesting specific modifications to the standard additional insured endorsements or by requiring the use of their own manuscript endorsement. Similarly, some indemnitees require indem-

nitors to provide evidence of compliance with the contract insurance requirements using a manuscript certificate of insurance. The intent behind such requests is to give the indemnitee assurance that it is actually receiving the coverage and other insurance entitlements (e.g., the right to receive notice of changes to the policy or notice of cancellation) that it expects.

Unfortunately, this tactic often backfires. Insurers frequently refuse to attach manuscript endorsements and issue manuscript certificates of insurance drafted by third parties, and understandably so. Not only do manuscript forms tend to impose additional obligations on the issuer, but they are untested by the courts, which limits the insurer's confidence in knowing what scope of coverage they are actually agreeing to provide. Likewise, manuscript certificates sometimes include statements that the representations made in the certificate are legally binding and/or that the issuer is certifying that the coverages listed in the certificate satisfy the contract insurance requirements. Many agents and brokers refuse to sign a certificate that includes this type of language, and again, this position is justifiable because it technically amounts to providing legal services that they are not qualified to provide and are not compensated for performing. Further, it introduces a significant errors and omissions exposure. These types of certificates may also violate state insurance regulations.

By demanding forms that are difficult, costly, or impossible to obtain, indemnitees introduce additional costs and barriers into the contracting process. The indemnitor may be forced to choose between breaching its contract, moving a carefully arranged and overall beneficial insurance program to another (possible inferior) insurer, or withdrawing from a potentially profitable business opportunity.

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Educate Indemnitees on Coverage Issues

Insurance requirements often get little or no attention and are frequently lifted from previous contracts without any consideration of why certain coverages are being requested, out-of-date terminology, or attention to insurance market conditions. By taking the time to educate indemnitees about unnecessary or unreasonable insurance requirements, indemnitors may be able to minimize delays or frustrations in the contracting process that will, hopefully, carry over to future contracts.

If an insurance requirement is unreasonable or unnecessary, ask the indemnitee to explain its reason for the requirement, and explain to them why it is unnecessary,

unobtainable, or costly to provide. In many instances, the extra protection indemnitees derive from requested policy modifications is minimal if any. A classic example is where the contract requires an endorsement to accomplish something that is already included in the policy form, such as requests for a "waiver of subrogation endorsement" or a "cross-liability endorsement" in the CGL policy. The standard CGL policy already allows insureds to waive subrogation in writing prior to a loss (i.e., in the construction contract), and includes a separation of insureds provision (also called a severability of interests provision) that preserves coverage for suits between insureds (cross liability).

Likewise, requests for additional insured status on the indemnitor's auto policy is redundant because the standard policy already includes in the "who is an insured" provision, "anyone else liable for the conduct of an insured." No endorsement is necessary to provide insured status to an indemnitee with regards to its vicarious liability for the indemnitor's negligence. Although a standard additional insured endorsement was issued for use on the auto policy to accommodate these types of requests, it does not provide any additional coverage that is not already in the policy. Rather, it merely reiterates that the person named on the endorsement is an insured to the extent the "who is an insured" provision already says they are an insured.

Consider Using Automatic AI Endorsements

Businesses that add others to their policies as additional insureds on an infrequent basis usually list each indemnitee by name. However, because this request is so common in construction contracts, many contractors use an automatic, or "blanket" additional insured endorsement to effect additional insured status. Blanket endorsements automatically provide additional insured status to parties that meet the criteria in the endorsement.

For contractors, two standard endorsements (CG 20 33 and CG 20 38) are available that automatically provide additional insured status to an owner, lessee, or contractor where such status is required in a written construction contract. With these endorsements attached to a contractor's policy, it is not necessary to specifically request additional insured status for each individual party the contractor agrees to make an additional insured. The difference between the two endorsements pertains to the type of contractual relationship that is required for additional insured status to be triggered. Endorsement CG 20 33 provides additional insured status to owners, lessees, or contractors who require additional insured status in a written construction contract with the insured. However, contractors are often required to provide additional insured status to upstream parties with whom they do not have a direct contractual relationship, and the language of this endorsement does not expressly reach those parties. For example, subcontracts often require the subcontractor to name the general contractor (who hired the subcontractor) and the project owner as additional insureds. Endorsement CG 20 33 will trigger additional insured status for the general contractor, but not for the project owner. Endorsement CG 20 38 applies a broader

rule, extending additional insured status not only to the party with which it has a contractual relationship, but also to other parties for whom additional insured status is required within that contract. Many nonstandard blanket endorsements follow a similar approach.

Whether additional insured status is provided separately for each indemnitee or collectively for all indemnitees, make sure the additional insured endorsement limits coverage to liability arising out of the intended operations, such as a particular construction project or a specific location. The standard ISO endorsements already do this, but manuscript or nonstandard blanket endorsements may not. The scope of coverage should be consistent with the customs and practices of the industry to avoid the need for constant modifications.

Additional Insureds and Workers Compensation Insurance

Contractors generally should not agree to add others as additional insureds on their workers compensation policies. The purpose of that policy is to cover the insured's statutory obligations for injuries to its employees. Consequently, as an additional insured, the indemnitee would have coverage for injuries to its own employees under the indemnitor’s workers compensation policy. Clearly, that result is not the intended one, as rarely, if ever, would a contracting party expect another to provide workers compensation coverage on its behalf. (Even if that was the indemnitee’s intent, most states’ workers compensation laws or insurance regulations prohibit the combining of coverage for unrelated entities in the same policy.)

When a party requests additional insured status on the workers compensation policy of an indemnitor, the intent is probably to protect itself from claims brought by the indemnitor's employees for injuries sustained on the indemnitee’s job. However, coverage for this type of claim (commonly referred to as a third-party-over action) is already provided under the indemnitor’s CGL policy, either directly to the indemnitee as an additional insured or through the indemnitor’s contractual liability coverage.

With all that said, there are two situations where a form of “additional insured” status may be used in conjunction with a workers compensation policy. One is when the employee of one organization performs work under the direct control or supervision of another. The most obvious example of this is a temporary employee provided by an employment firm. Another example might be when a contractor borrows or rents a piece of equipment and someone to operate the equipment from another contractor. In many, perhaps most, situations involving temporary use of another’s employee, the regular employer is responsible for providing workers compensation insurance on that employee. However, under the borrowed servant doctrine, the borrowing contractor may be legally liable for the borrowed employee's workers compensation benefits.

The normal method of allocating this risk is to isolate coverage to the regular employer’s policy (the party lending the employee to the contractor) by attaching an

alternate employer endorsement (WC 00 03 01 A) to the regular employer's policy. This endorsement provides coverage to employees injured while working for the specified alternate employer as though that party were an insured under the policy. The endorsement also stipulates that the insurer will not ask the alternate employer's insurer to share in a loss covered by the endorsement.

Additional Insureds and Completed Operations

Often, construction contracts stipulate a time period beyond the term of the contract during which the additional insured will be provided with completed operations coverage. Standard additional insured endorsements, and most nonstandard endorsements, do not extend coverage for liability arising out of completed operations. A separate standard endorsement (CG 20 37) has been traditionally used (and remains available for use) for providing an additional insured with completed operations coverage. This endorsement must be attached to the policy in effect at the time of completion and on all policies purchased after the project has been completed for as many years as required in the contract. For example, if a contractor agrees to provide additional insured coverage to a project owner for 5 years after a project's completion, each successive policy issued during that 5-year period must include endorsement CG 20 37 (or equivalent endorsement) and list the project owner in the endorsement schedule. This endorsement must be attached to the policy in effect at the time of completion and on all

Consider Contractual Obligations in Selecting Limits

With each contract they sign, a contractor's aggregate liability exposure increases. Agreements to indemnify or make someone

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an additional insured magnify the increased risk, and the broader these agreements are, the bigger the potential impact. Contractors must take all of these factors into account in determining the appropriate limit of insurance to carry.

Unless endorsed otherwise, the limits of insurance apply on a blanket basis to all covered claims. A claim in connection with one project, therefore, reduces the available limit for claims arising out of other projects. While a contractor can satisfy its contractual obligations by purchasing a limit equal to or greater than the highest limit required in a contract, the contractor must consider its own coverage needs as well as its indemnitees'. A contractor who purchases just enough coverage to satisfy its highest required limit has satisfied its contractual obligations, but if the insurance purchased is insufficient to pay all claims, the contractor is still liable for those amounts.

To illustrate, suppose an electrical subcontractor works on 30 projects in the course of a policy period. Each subcontract requires the subcontractor to carry a minimum of $1 million of general liability insurance. This subcontractor can comply with all subcontracts' insurance requirements by purchasing a policy with a $1 million each occurrence and general aggregate limit. However, a large claim on one project may leave little or no coverage for claims arising out of the other 29 projects. A better strategy might be to either purchase a higher general aggregate limit (e.g., $2 million or $5 million) or request that the policy be modified to provide a separate general aggregate limit for each of the contractor's projects. (Sometimes indemnitees require a separate limit of liability for their project.) Contractors can attach an endorsement, such as ISO's Designated Construction Project(s) General Aggregate Limit Endorsement (CG 25 03), to modify the policy to provide a separate limit of insurance for claims arising out of each designated project. This approach protects indemnitees by providing dedicated coverage for each project, and also protects the contractor from a depletion of its coverage as a result of a single catastrophic claim.

In 2019, endorsement CG 25 45 was introduced. It provides for a separate designated projects products-completed operations aggregate limit for specific projects listed in the endorsement. This type of endorsement can be tailored to the risks associated with each specific project.

There are also endorsements that allow for enhancement of the products-completed operations limits. Endorsement CG 25 04 affects the general aggregate, while CG 25 46 allows for a separate products-completed operation aggregate for each designated location listed in the endorsement.

Summary

Construction contracts impose many duties, obligations, and liabilities on contractors. Although great attention may be paid to the operational issues addressed in these contracts, such as scheduling, payment, and changes clauses, the risk and insurance implications of various contract provisions often receive little attention.

Unfortunately, many construction contracts are drafted by practitioners who have little

understanding of the details of insurance coverage and the practicalities of the insurance marketplace. As a result, it is not unusual for contracts to contain insurance requirements that are out-of-date, unnecessary, or unobtainable. Many contractors accept these onerous contractual provisions, often without even noticing them, particularly when the business climate is very competitive. Even where the risks are understood and accepted, the execution of the risk transfer can fail to achieve the intended purpose.

A contract review by a knowledgeable risk manager or insurance agent can help avoid unexpected surprises in how the insurance program responds to contractual allocations of risk. An attorney knowledgeable about indemnity agreements and insurance coverage can also be a valuable resource in ensuring that the risk transfer is effective. Although contractors will not always be able to negotiate the terms they would like, they can make informed decisions to plan for the risks they accept in their construction contracts and execute them in the most effective manner.

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