

CONSTRUCTION RISK MANAGEMENT: TEN ISSUES IN CONSTRUCTION CONTRACTS

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Mr. Bobotek concentrates his practice on a variety of insurance coverage, risk management and risk allocation issues, with an emphasis on those arising in the construction industry. Mr. Bobotek counsels clients in formulating risk management strategies, obtaining insurance cover, developing contractual insurance requirements, analysis and resolution of insurance coverage claims and disputes, and all phases of development and construction of commercial properties, including preparation, review and negotiation of development, design, construction, design-build, and related agreements.

In the world of construction, whether you are a lender, owner, contractor, or subcontractor, your success hinges largely on risk management. While there is no substitute for sound business and construction practices (such as proper preconstruction planning, proven construction means and methods, use of experienced personnel, and stringent safety programs), among the most important project risk allocation tools are the contracts governing the various parties' rights and obligations. Within those contracts, risk is primarily allocated through indemnity and insurance requirement provisions. Proper risk management practices, however, are not limited to risk allocation. Equally important is careful contract preparation and review. Set forth below is a brief overview of some of the most important risk management concepts to consider when preparing or entering into your next construction contract.

1. Risks Should Be Transferred to Those In the Best Position to Control Them

Owners and contractors should anticipate potential project risks and determine whether it is more advantageous to retain or transfer them. From a risk management perspective, it is crucial to spread

the project risks to the parties most able to manage them. Owners, especially those not well-versed in the nuances of the construction industry, should strive to limit the number of parties with whom they contract. The owner should engage a project architect, and then place responsibility for engagement and oversight of all other design professionals on the architect, who is in a much better position to oversee these consultants' services than the owner. The same is true for the project's construction activities; the owner should enter into a contract with the contractor, who will engage all subcontractors. Subcontractors should, in turn, engage sub-subcontractors, materialmen, and suppliers. In this fashion, the overall project risks may be spread to those with the greatest ability to control them.

2. Don't Include Overly Onerous Contractual Requirements

The best way to achieve successful completion of the project on time and within budget is to foster a collaborative project environment. This begins with the contracting process. While it is advisable to clearly address all anticipated risks in the contract, it serves no useful purpose to force an onerous, one-sided contract on contractors and subcontractors. Draconian

indemnity, warranty, and payment provisions will not only drive project costs up, but may also engender a more adversarial relationship between the contracting parties. In addition, courts may not uphold them.

3. Back Up Indemnity Provisions With Insurance

Contractual indemnity provisions included in contracts are only as good as the indemnitor's ability to honor them. Because it is often difficult to adequately vet a contractual partner's finances and work/safety history, requiring the proper amount and type of insurance is a crucial risk management component. When transferring risk through indemnity, it is important to ensure that the transferee has, or is able to procure in a cost-effective manner, insurance coverage sufficient to handle the assumed risk. One caveat at is that some risks included in an indemnity agreement, such as liability arising out of an indemnitor's intentional misconduct, are not insurable. Do not let lack of insurability for such conduct serve as a valid argument for negotiating responsibility for it out of an indemnity agreement.

4. Tailor Insurance Requirements to the Discipline

When preparing insurance requirements for construction-related contracts, make sure that the indemnity and risk obligations associated with each project discipline are identified and addressed.

- a. Design Professionals (architects, engineers, etc.). Design professional contract requirements

should include auto and commercial general liability, workers compensation/employers liability and, most importantly, professional liability. Pay particular attention to the limits of the professional liability coverage; requiring excess limits for the professional liability coverage may be appropriate depending on the project's size. Consider requiring that the coverage be "project specific" either through a separate project policy or sub-limits applicable only to the project. For large projects, an owner may wish to consider obtaining owners protective professional insurance coverage, which indemnifies the owner directly for losses arising out of professional negligence of architects/engineers exceeding the limits available under architects'/engineers' own professional liability policies.

- b. Contractors and Subcontractors. Those entities performing construction work on the project should be required to carry auto and commercial general liability insurance, workers compensation/employers liability, and an excess liability policy providing coverage over the auto and CGL policies' limits. Many owners also insist on payment and performance bonds from contractors and/or subcontractors. For those contractors and subcontractors performing any design-build functions, professional liability coverage should also be required. To prevent coverage gaps, contractors and subcontractors' insurance requirements should include pollution liability coverage. If the owner will procure the

property or builders risk coverage, contractors and subcontractors should consider the need for an "installation floater" or similar coverage to protect their equipment and supplies on-site, offsite, and in transit.

- c. Property/Builders Risk Coverage. While the liability coverage referenced above covers most project accidents resulting in (i) bodily injury, and (ii) damage to property other than what is being constructed, in most cases it does not cover damage to the structure being built. While it is possible to cover damage to construction projects under an owner's existing property policy, there are coverage limitations in standard property insurance forms that make procurement of a builders risk policy desirable in most cases. If a builders risk policy is procured, consideration should be given to whether the owner or the contractor obtains it. This determination is best made on a project-by-project basis, taking into consideration such factors as the type of project (i.e., new construction or renovation of an existing structure), type of contract (cost plus or stipulated sum), financing/lender's requirements (owner may want to "bundle" soft cost and loss of income coverage with the builders risk policy to avoid claim delays and argument among insurers over coverage), the presence of a master property program (owner or contractor), location of project, the parties' relative economic leverage to negotiate the most favorable premium and coverage, the contractor's level of sophistication, and

the owner's desire to participate in project-specific risk management.

5. Address Potential Coverage Gaps

Numerous risk management products, including insurance policies and bonds, are required to cover the risks presented by a construction project. To the greatest extent possible, the coverage provided by these policies should fit together. Policy provisions are drafted to create in one policy the exact coverage that was excluded by another policy. Have your broker and/or attorney review the entire insurance program to prevent gaps in coverage. You may need to amend one or more of your policies through endorsements, or purchase additional coverage, to close these gaps.

6. Add Protection By Including Additional Insured Requirements

Make sure that you require all downstream contractors and/or subcontractors to add you as an additional insured under their liability policies. Additional insured status adds a layer of protection to an owner's or contractor's indemnity requirements. A key advantage is that an insurer has an up-front duty to defend claims made against additional insureds, whereas most indemnity provisions require only that the indemnitee provide reimbursement of any defense costs. Include a requirement in your contract that the additional insured endorsement be broad enough to cover both ongoing and completed operations, as well as your liability arising out of the work, on a primary and non-contributory basis. Be sure,

however, not to ask to be named as an "additional named insured," as this may include undesirable obligations such as paying a deductible, self-insured retention, or premium if the first named insured fails to do so.

7. Ensure That Waivers of Subrogation Are in Place.

Proper transfer of many project risks from the contracting parties to their insurers is achieved through inclusion of waivers of subrogation. These waivers prevent insurers from passing risk back to downstream project parties by precluding insurers from seeking reimbursement from other project participants for amounts paid on claims. Because an insurer "stands in the shoes" of its insured when bringing a subrogation claim, it cannot bring such a claim if its insured has waived this right in its contract with the allegedly culpable party. For this reason, waivers of subrogation ensure that transferred project risk stays with the insurers.

8. Don't Rely on Certificates of Insurance

Many parties to a construction project fail to adequately confirm that insurance requirements have been satisfied, either upon execution of the contract or throughout the duration of the project. Required coverage limits, additional insured status, and waivers of subrogation provide no benefit if they were not obtained, or are permitted to lapse. It is common for owners and contractors to rely on a cursory review of certificates of insurance to "confirm" compliance with insurance requirements. This practice is

extremely risky, as many insurance certificates include incorrect and/or incomplete information, such as omitting mention of risk-changing exclusions or endorsements. In addition, most certificates of insurance are prepared using an industry-standard form. Courts have found that these forms are so replete with express disclaimers that they are not legally binding on the party providing them. As such, it is advisable to require in the contract not only a certificate of insurance and endorsements evidencing the proper insurance coverage, additional insured status and waiver of subrogation, but also delivery of a copy of the applicable insurance policies. Performing a diligent review of the information provided will greatly diminish, if not remove, the anguish, costs and lost time suffered upon discovery, after a claim is made, that the putative coverage identified in the certificate of insurance is not what the actual policies provide, and is not what was required under the relevant contract.

9. Have Contracts Reviewed by a Knowledgeable Attorney to Ensure that all Contracts Are Consistent and Current

All too often, owners and contractors fail to ensure that the various contracts into which they have entered are consistent with both the market and one another. Dispute resolution provisions should be harmonized to avoid inconsistent results caused by an inability to include all parties in the same proceeding. Project lenders' and owners' requirements regarding payment timing and limitations must be properly flowed down. To steer

clear of surprises when claims arise, as well as unnecessary project delays, subcontractor, sub-subcontractor, supplier and materialmen contracts must include the proper flow-downs required by upper tier contracts. Many lenders, owners, and contractors use form contracts with insurance and indemnity requirements that are outdated, unenforceable, or otherwise unobtainable. Forcing a design professional, contractor, or subcontractor to obtain insurance in a form that is no longer offered, or offered only at a cost-prohibitive premium, is not in the project's best interest. To avoid these problems, it is crucial to have an experienced attorney scrutinize your contracts.

10. Read the Contract Before Executing It

Lastly, there is no substitute for reading each contract very carefully before signing it. Beyond the obvious problems of errors and inaccurate information that creep into negotiated contracts, careful review may reveal additional risks, improperly allocated risks, and other issues. No agreement is perfect, but vigilant contract review is one of the most crucial steps in the risk management process.