The success of construction lenders, owners, contractors or subcontractors may depend on how well each of them addresses project risks. This is called “risk management.” A major part of risk management is “risk allocation,” whereby a party assigns by contract the responsibility for a certain risk to another party, who will then bear that risk. Yet another part of risk management is the manner in which a party handles its assumed risk so that the possibility (and resulting cost) of the risk is minimized.

Some of the most important risk management tools at a party’s disposal are the contracts into which it enters with others involved in the construction project. Within those contracts, risk is primarily allocated through indemnity and insurance requirement provisions. Managing risks can be handled not only by sound business and construction practices (such as proper preconstruction planning, proven construction means and methods, use of experienced personnel, and stringent safety programs) but also by careful contract preparation and review. What follows is a brief overview of some of the key risk allocation and risk management concepts to consider when preparing or entering into your next construction contract.

Allocating Risk to the Party That Is in the Best Position to Control That Risk

A fundamental risk management concept is that owners and contractors should anticipate potential project risks and determine whether it is more advantageous to accept responsibility for each risk or to allocate responsibility for that risk to another party. From a risk management perspective, it is important to assign a project risk to the party best able to control and manage it. For example, a project owner will want to allocate the risk that someone is hurt by construction operations to the contractor, who is in the best position to provide a safe work site. A contractor will want to allocate the risk of design errors to the owner, who often holds the contract with the architect and therefore is in a better position to address and minimize these losses. These are the types of risks that a construction contract should address, so that the parties know in advance who is
Allocating Risk Through Indemnity Provisions

An indemnity provision generally is a section in a contract that requires one party to pay for losses incurred by the other party (and, often, to defend the other party against claims for such losses) as a result of claims made by third parties. Following up on the risk allocation example set forth above, a construction contract indemnity provision often requires the contractor to indemnify and defend the owner from and against claims for bodily injury and property damage that arise from the negligence of the contractor or one of its subcontractors while performing the work. Another indemnity clause may require the owner to indemnify and defend the contractor from and against claims based on the existence of hazardous materials on the project site over which the contractor has no control.

Backing Up Indemnity Provisions With Insurance

Contractual indemnity provisions included in contracts are only as good as the indemnitor’s ability to honor them. The indemnitor must have the financial ability to satisfy its indemnification obligations. Accordingly, when transferring risk through an indemnity provision, it is important to ensure that the transferee (or the indemnitor) has, or is able to procure in a cost-effective manner, insurance coverage sufficient to pay for the assumed indemnity obligations. One caveat to this general principle is that some risks allocated in an indemnity provision, such as liability arising out of an indemnitor’s intentional misconduct, are not insurable due to moral hazard and/or public policy considerations. The lack of insurability for such conduct, however, does not necessarily constitute a valid argument for not requiring the indemnity—the party best able to control the loss should be the one indemnifying the other party from and against that loss, regardless of whether insurance is available to backstop the indemnity.

Insurance Is a Fundamental Way to Manage Risk

If a party has responsibility for a type of loss on a project, it will want to obtain insurance for that loss to minimize its costs, should the loss be realized. Accordingly, when preparing insurance requirements for construction-related contracts, it is important to identify and address the risk obligations associated with each project discipline and to make sure that the limits are adequate to address possible losses.

Design Professionals

Contract insurance requirements for design professionals (e.g., architects, engineers, etc.) should include auto and commercial general liability; workers compensation/employers liability; and, most importantly, professional liability insurance. The limits of design professionals’ professional liability coverage are particularly important. Because a professional liability policy typically will cover losses arising on all of a design professional’s projects, not just your project, it is important that the aggregate limit be sufficiently high. Indeed, owners often consider requiring excess limits for professional liability coverage or requiring that the
coverage be “project specific” either through a separate project policy or sublimits applicable only to the project. For large projects, an owner also may wish to consider obtaining owners protective professional liability insurance coverage, which indemnifies the owner directly for losses arising out of the design professional’s professional negligence that exceeds the limits available under the design professional’s own professional liability policy.

Contractors and Subcontractors
Those contractor and subcontractor entities performing construction work on the project should be required to carry automobile liability, commercial general liability (CGL) and workers compensation/employers liability policies, as well as an excess liability policy providing coverage over the automobile and CGL policies’ limits. For those contractors and subcontractors performing any design-build functions, professional liability coverage also should be required. To prevent coverage gaps, contractors’ and subcontractors’ insurance requirements should include pollution liability coverage. If the owner will procure the property or builder’s risk coverage, as discussed below, contractors and subcontractors should consider the need for an “installation floater” or similar coverage to protect their equipment and supplies on-site, off-site, and in transit.

Property/Builder’s 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 or the materials being used. This damage, however, can be covered by obtaining a “builder’s risk” policy. While it is sometimes 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 builder’s risk policy desirable in most cases. If a builder’s 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 (e.g., 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 builder’s 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. That being said, it is more common for owners than contractors to purchase builder’s risk insurance, which covers the interests of all of the other parties having an interest in the project.

Surety Bonds Are Also Used to Manage Risk
The risks of nonperformance and of nonpayment are shared by owners, contractors and subcontractors of all tiers. Both of these risks can affect the timely and on-budget completion of the project. For this reason, owners
often require contractors to post a performance bond, which typically obligates the issuer of the bond (known as the “surety”) to complete the project if the contractor is terminated, and a payment bond, which typically obligates the surety to make payments due from the contractor to subcontractors if the contractor does not do so. Likewise, contractors will require payment and performance bonds from subcontractors to mitigate the risk of subcontractor nonperformance and failure of subcontractors to pay sub-subcontractors or suppliers. In some instances, contractors will use “subcontractor default insurance” that will reimburse the insured contractor for damages incurred as a result of the subcontractor’s failure to perform.

Addressing Potential Insurance and Bond Coverage Gaps

As discussed above, many risk management products, including insurance policies and bonds, are required to cover the risks presented by a construction project. Insurance policy provisions are drafted to create in one policy the exact coverage that is excluded by another policy. To the greatest extent possible, the coverage provided by these policies should fit together. It is therefore wise to have an insurance broker and/or attorney review the entire risk management program to identify gaps in coverage and to suggest amendments, endorsements and additional coverage to close these gaps.

Adding Protection by Including Additional Insured Requirements

Owners and contractors should require all downstream contractors and/or subcontractors to add the owner and contractor as an additional insured under the downstream parties’ liability policies. Additional insured status adds a layer of protection not only to an owner’s or contractor’s indemnity requirements but also to its own insurance coverage. A key advantage to being an additional insured is that the 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. When drafting additional insured provisions, it is often advisable to include a requirement that the additional insured endorsement be broad enough to cover both ongoing and completed operations, as well as the additional insured’s liability arising out of the work, on a primary and noncontributory basis. Be sure, however, not to ask to be named as an “additional named insured,” as this may impose undesirable obligations such as paying a deductible, self-insured retention or premium if the first named insured fails to do so.

Ensuring That Waivers of Subrogation Are in Place

Including waivers of subrogation ensures that many project risks are properly transferred from the contracting parties to their insurers. Basically, such provisions 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.
Don’t Rely on Certificates of Insurance

Many parties to a construction project fail to adequately confirm that the project 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. Owners and contractors frequently rely on a cursory review of certificates of insurance to “confirm” compliance with insurance requirements. This practice is 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 evidencing the proper insurance coverage, additional insured status and waiver of subrogation but also delivery of applicable endorsements (if not the full policies themselves) evidencing such coverage. 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 coverage identified in the certificate of insurance in fact is not what the actual policies provide and is not what is required under the relevant contract.

Before Signing, Have Contracts Reviewed by a Knowledgeable Attorney and Read Contracts for Consistency

Each construction project includes multiple contracts, all of which should be consistent and complementary. For example, dispute resolution provisions should be harmonized so that all parties involved can be in the same proceeding at the same time; this will avoid inconsistent results that may arise if there are several different cases addressing the same issues. Project lenders’ and owners’ requirements regarding payment timing and limitations should be properly flowed down into all project contracts so that payment provisions are consistent throughout the contracts. In addition, many lenders, owners and contractors use form contracts with insurance and indemnity requirements that are outdated, unenforceable or otherwise unobtainable. Forcing a party 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 review the contracts. Just as important, there is no substitute for each party reading its contract very carefully before signing. 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 that a lawyer, who often is not as familiar as the client with the project, would not catch. Remember always that few agreements are perfect and that vigilant contract review is one of the most crucial steps in the risk management process.