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MANAGING RISK OF LOSS ON CONSTRUCTION PROJECTS: INSURANCE AND BONDS

MUNICIPAL ATTORNEYS ASSOCIATION

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Risk Management On Construction Projects

There is no way to totally anticipate, or control, losses on construction projects. It is an industry dealing with unknown sub-surface conditions, hazardous materials, open to unexpected weather delays – and it is heavily dependent on **people**.

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Risk Management On Construction Projects

All that an owner can do is try to *minimize* the risk of loss, and aside from pre-qualifying and closely monitoring contractors, most public owners also protect themselves by requiring **insurance** and **surety bonds**.

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Risk Management On Construction Projects

Bonds and insurance do two entirely different things.

Insurance is purchased to cover the risk of things that (theoretically) within the control of the contractor.

Bonds are purchased to cover the risk that the contractor won't do what he agreed to do (properly do the work and pay his bills).

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Insurance On Construction Projects

As an owner, you don't just care about whether the contractor has insurance.

You care about whether the contractor has the *right* insurance.

And, obviously, the only time you can assure this is **before the work starts**. After there is an "occurrence," it will be too late to fix holes in insurance coverage.

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Insurance On Construction Projects

Your job of assuring proper insurance coverage is made infinitely more difficult by the insurance companies themselves.

This is because ***insurance companies are the smartest people in the country*** **–** maybe the world.

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Insurance On Construction Projects

Insurers only have two ways to make money: either make it in the **market,** investing premium dollars and getting interest/dividends/appreciation, or **lowering costs** by (among other things) not having to pay out on claims.

Insurance On Construction Projects

How do they avoid paying out on claims? Two ways:

a. **Prequalify** the insureds
b. Limit the things they will cover in policies – **by excluding coverage**

Insurance On Construction Projects

The only way to assure that you will get the insurance coverage your client needs is to ***require it, specifically***.

Insurance On Construction Projects

What do you care about?

WHO is the insurance company?

a. What is the **rating** of the insurer?

b. Is it **admitted** in your state?

Insurance companies have been known to go out of business, and then (at best) you are dealing with a state insurance fund. You do not want to end up there.

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Insurance On Construction Projects

How much insurance is the contractor buying?

a. If you ask for **too little,** your client has uninsured exposure

a. If you ask for **too much,** some small contractors and subcontractors may not be able to get it

You need to talk to your client and its risk managers to decide on the right amounts. This is not something that should be left up to lawyers to decide.

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Insurance On Construction Projects

The amount of insurance is just the first item to check. You then have to make sure that these limits will **cover the kinds of claims** you might actually have.

- Most CGL policies strip all the risky stuff out through **exclusions**
- Then they put back some coverages back in through **endorsements**

This is how the insurers limit risk to *just the specific coverages negotiated*.

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Insurance On Construction Projects

You *cannot* just rely on a "Certificate of Insurance."

a. These forms are from an **agent**, not the company.
b. They only tell you the **company name** that is issuing coverage, **policy number** and **limits of coverage**.
c. They tell you **NOTHING** about exclusions, sub-limits or endorsements.

If you want the details, ***you have to ask for them***.

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Insurance On Construction Projects

You should care about is **HOW LONG** the insurance has to be in place:

a. Only until the **work is done**?
b. Only for a **set number of years** (like 1 or 2)?
c. Through the **statute of limitations**?
d. Through the **statute of repose**?

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Insurance On Construction Projects

Through those exclusions and endorsements, many of the "standard" clauses of a policy can be changed, so you need to **give the bidders specific instructions** about the kinds of issues you care about.

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Insurance On Construction Projects

Some of the differences among these policies are:

- Will they cover **claims from day one**, even if the contract hasn't been signed yet? (and how does this affect contractors starting on a "letter of intent"?)
- Will they cover **claims that are only asserted during construction**, but not ones that only come in after construction is complete ("completed operations coverage")?
- Will they only cover claims **after the additional insured's own insurance is first exhausted**?
- Will they only cover **additional insureds who are specified in the written contract**?

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Insurance On Construction Projects

DO NOT RELY ON "BOILERPLATE" LANGUAGE IN FORM CONTRACTS FOR INSURANE REQUIREMENTS!!! It will never, ever be specific enough to protect you.

You should come up with your ***own language*** for exactly what insurance you will accept. (Again, this is where the professional risk manager comes in!)

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Insurance On Construction Projects

ADDITIONAL INSURED ENDORSEMENTS.

Your client's *contract* probably says that it will be an "**additional insured**." This is important. It means that if the owner gets sued for something that is the contractor's fault (improperly placed ceiling tile falls on person at City Hall), the owner can turn to the contractor's insurer (even if the contractor is out of business) to defend it for the improper construction.

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Insurance On Construction Projects

But ***the insurance company didn't sign that contract***. It has **NO** obligation to the owner, just because the *contractor* made a promise to cover the client.

You have to make sure that the policy actually includes the owner.

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Insurance On Construction Projects

In order to be covered as an additional insured, the insurer has to issue an **"additional insured endorsement." ("AIE")**

There are *hundreds* of different forms of AIEs out there, and you have no way of knowing which one your contractor has purchased (if any).

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Why are there **so many different forms**?

Because insurers will, generally, start with the AIE that is likely to place the fewest obligations on the insurer. Insurers can, and often do, agree to broader AIEs, but you can't tell from a Certificate of Insurance what your contractor purchased.

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The reason that this has **become such a big issue** for insurers is that they figured out that the amount of money they were paying to hire lawyers to defend all these additional insureds was cutting into the bottom line. So, to "correct" this problem, they have tightened up on who they will cover.

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Insurance On Construction Projects

So what can you do for your client? The way to protect your client is through **contract language** and **follow up**, to

(a) **SPECIFY** what you want in the contract, and

(b) **DEMAND to see the actual AIE** before you let the contractor start work

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Insurance On Construction Projects

Put the right language in the contract. Put in the contract either very specific wording of what you are requiring, or cite to an "ISO (Insurance Services Office) form number "or equivalent" to let the contractor's insurance agent know what you want.

Again, you get this information from the client's risk manager.

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Insurance On Construction Projects

Demand to see the form. Put in the contract that **the contractor cannot start work** until someone from the client sees and approve the AIE. (The contractor's agent can spit the form out of his/her computer and send it to you.)

Then have the risk manager approve it.

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If the contractor knows that he can't start work until the form is approved, but his contract time is ticking and he may end up with liquidated damages, the contractor will have a "little chat" with his agent, and get you the form quickly.

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Insurance On Construction Projects

Notice of Cancellation Endorsement

Almost **all** construction contracts also contain language that requires the insurance company to give advance notice of cancellation to the owner or additional insureds.

But this is a true "gotcha," because almost **no** insurer will actually obligate itself to do this.

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Why? Because insurers don't like to be in the position of having to cover claims for clients who didn't pay their premium, or lied on an application, just because the insurer made a mistake and didn't give someone notice of cancellation. **The insurers don't want to take that risk**.

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Insurance On Construction Projects

There is a box on the Certificate of Insurance for "Cancellation". This box *used to say*

> Should any of the above-described polices be cancelled before the expiration date thereof, the insurer **will provide** written notice to the certificate holder named herein 30 days' prior to the effective date of cancellation.

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Then, insurers changed the "standard form language" to say

> Should any of the above-described polices be cancelled before the expiration date thereof, the insurer **will endeavor to mail 30 days' written notice** to the certificate holder named herein, but failure to do so shall impose no obligation or liability of any kind upon the insurer, its agents or representatives.

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Insurance On Construction Projects

Now, the "standard form language" says

> Notice of cancellation shall be given **in accordance with the provisions of the policy** of insurance.

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Insurance On Construction Projects

And guess what?

There probably is **NOTHING** in the policy about giving notice of cancellation, so your client may never know that it has an uninsured contractor on its property!!

Again, that Certificate of Insurance only says that the contractor had insurance on a specific date. It may also give a renewal date, but nowhere does it promise that the insurance won't be canceled before then.

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Insurance On Construction Projects

The only way to know if the insurance has been cancelled is to get the insurer to give you a "**Notice of Cancellation Endorsement.**"

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Insurance On Construction Projects

As with the Additional Insured issued, the way to protect your client is to

(a) **SPECIFY** what you want in the contract, and
(b) **DEMAND** to see the actual notice of cancellation endorsement *before your client lets the contractor start work*.

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Insurance On Construction Projects

But **warning**! Even if your client gets an endorsement, **IT IS VERY HARD TO GET A NOTICE OF CANCELLATION *THAT REALLY REQUIRES NOTICE*** - not impossible, but very, very hard.

Insurers HATE to agree to do this, so most of the endorsements say "I will give notice but you agree that you can't blame me if I don't."

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Insurance On Construction Projects

NOTICE OF CANCELLATION TO THIRD PARTIES

B. This advance notification of a pending cancellation of coverage is intended as a courtesy only. Our failure to provide such advance notification will not extend the policy cancellation nor negate cancellation of the policy.

Liberty Insurance Corp LIM 99 01 05 11

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Insurance On Construction Projects.

If you absolutely can't get an agreement to give you prior notice before insurance is canceled, your only other option is to require **updated certificates of insurance on a monthly basis**, as at least some assurance that the contractor paid his monthly premiums and the insurance is still in place.

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Insurance On Construction Projects.

Other issues: **sub-limits** and **exclusions**.

Certificates of Insurance will tell you what the limits of insurance are. They **will <u>not</u> tell you** if the contractor has any "**exclusions**" from its standard insurance for expensive risks.

You can insert language in the contract limiting what kinds of exclusions would be acceptable.

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Insurance On Construction Projects.

Other issues: **sub-limits** and **exclusions**.

Even if the contractor has coverage for a risk, it may have agreed to a smaller **sub-limit** for it (this is common for mold coverage). It could be as little as $5,000.

You can't tell this from the policy.

But you can insert in the contract that the contractor agrees to NOT have sub-limits.

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Insurance On Construction Projects.

Self-Insured Retentions and **Deductibles**.

Just as a health insurance policy will have a deductible that the insured has to satisfy, insurance programs for construction companies will have deductibles or **Self-Insured Retention** ("SIRs"). What most owners care about (or should care about) the most is "How much is it?" A $5,000 deductible is something that most contractors can cover, but what if the contractor raised it at $50,000, in order to get a lower insurance premium? Will the contractor have the cash to cover these costs? And if it doesn't have the cash, who will pay the claim?

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Insurance On Construction Projects.

You can insert language in the contract that limits how much the deductible or SIR can be.

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Insurance On Construction Projects.

What's your client's remedy if the contractor didn't get the right insurance?

If the contractor doesn't get the insurance it agreed to, you have a **breach of contract** – which means you could now have a bond claim!

Of course, if the contractor is big and has reserves, it may be able to solve its own problem. But if not, there may still be hope.

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Insurance On Construction Projects.

What's your client's remedy if the contractor didn't get the right insurance?

If the contractor forwarded your insurance requirements to its agent, and the agent confirmed that all the right coverages had been purchased but the agent was wrong, the contractor could have a claim against the agent – who probably has **professional liability insurance**.

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Insurance On Construction Projects.

You cannot be an expert on the best insurance language.

You won't have access to or even know about all the most current forms of endorsement or what is "available" in the market.

The best that you can hope for is to have a **risk manager/agent/broker** who understands all this stuff reviewing the forms for you and your client.

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Insurance On Construction Projects.

You also cannot expect insurance to cover all risks. Even the risks that are insurable. But you can increase the odds that your client's claims will be covered by:

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Insurance On Construction Projects.

a. **writing the best contract language you can come up with**. Steal language from other contracts you see, keep a file or folder with ideas.
b. having a ***really good risk manager*** to advise you
c. Get the client to have SOMEBODY who knows what he/she is doing **reviewing certificates and endorsements** as they come in, and
d. following up to get issues resolved ***before the contractor starts work*** and a claim could possibly arise

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Surety Bonds On Construction Projects.

Surety bonds are **totally different than insurance**. They are purchased to assure that the contractor fulfills his contract. They are generally required for public projects in Missouri.

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Surety Bonds On Construction Projects.

There are lots of different types of surety bonds, but the ones you will deal with most are **performance bonds** and **payment bonds.**

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Surety Bonds On Construction Projects.

The **performance** bond is given to promise that if the contractor doesn't complete all of its contractual obligations, the surety will.

The **payment bond** is given for the benefit of subs and suppliers, to assure that they will be paid.

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Surety Bonds On Construction Projects.

Both types of bonds are governed **STRICTLY by their terms**, so it is essential that you dictate the form of the bonds your client will accept.

Some of the things that you care about are:

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Typical Surety Bond Issues.

WHO is the "obligee" – the party who can make a claim.

If your construction project involves a municipal bond issue, you may want to include the bond holders as "**co-obligees**" on the surety bonds.

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Typical Surety Bond Issues.

WHO is the "obligee" – the party who can make a claim.

On a payment bond, you want the coverage to be **as broad as possible** – not just firms who have contracts directly with the contractor, but anyone who doesn't get paid.

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Typical Surety Bond Issues.

WHO is the "obligee" – the party who can make a claim.

If your client has a strong interest in assuring that a general contractor pays all its bills, encourage it to **provide a copy of the payment bond to all potential claimants**.

This is because the time for them to make a claim may be short, and they may have no other recourse.

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **make a claim**? *What does the bond say?*

Sometimes small subs and suppliers don't make a payment bond claim in time. Your client can assist them by **giving the surety notice of potential payment bond claims on their behalf** (to avoid a "prejudice" claim by the surety).

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **make a claim**? *What does the bond say?*

On a payment bond, it is typical for there to be a **pretty short time to file a claim** (like, 90 days). The purpose is that is the sub/supplier hasn't been paid, it is usually obvious and the sooner it is dealt with, the better.

These short times to file claims have been enforced by Missouri courts where the surety can show prejudice, although the trend is to require the surety to raise this as an affirmative defense. ***Thomas v. A.G. Electrical Inc.,*** *304 S.W. 3d 179, 188 (Mo.App. 2009)*

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **make a claim**? *What does the contract say?*

On a performance bond, it would be unusual to see any language about time to file a claim, since defects may not be discovered for a long time. *The sureties will look to the wording of the contract to see what claims are covered.*

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **make a claim**? *What does the contract say?*

On a performance bond, there are two kinds of **post-completion claims** that could be made:

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **make a claim**? *What does the contract say?*

1. **Indemnification claims**, which only come up when the owner gets a claim itself, generally for **tort** claims, that could be 5 years. *If you required insurance/AIE status and the insurer won't cover the claim, you have a breach of contract, and that should be covered by the bond.*
2. **Breach of warranty claims** if the work fails sooner than was promised, and **this turns on what the contract says about warranties**.

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **make a claim**? *What does the contract say?*

You do not want to cut off your client's right to seek compensation from a surety prematurely by agreeing to language in a contract or a bond that limits the kinds of claims that will be covered – ***but it happens all the time***!

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Typical Surety Bond Issues.

HOW LONG does the claimant have to **file suit**?

On a payment bond, it is not unusual to see language that limits lawsuits to 1-2 years:

AIA A312 Payment Bond (2010) § 12 "No suit shall be commenced. . . After the expiration of **one year** from the date (1) on which the Claimant sent a Claim to the Surety. . . or (2) on which the last labor or service was performed by anyone under the Construction Contract. . . ***whichever. . . occurs first***. If the provisions of this Paragraph are void or prohibited by law, the minimum period of limitation available to sureties as a defense in the jurisdiction shall be applicable."

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Typical Surety Bond Issues.

HOW LONG does the claimant have to **file suit**?

On a performance bond, it is not unusual to see similar language that limits lawsuits:

AIA A312 Performance Bond (2010AIA A312 (2010) §11 ("Any proceeding, legal or equitable, under this Bond . . . shall be instituted **within two years** after a declaration of Contractor Default or **within two years** after the Contractor ceased working or **within two years** after the Surety refuses or fails to perform its obligations under this Bond, **whichever occurs first**."

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Typical Surety Bond Issues.

HOW LONG does the claimant have to **file suit**?

Both of these are **unenforceable** in Missouri, where by statute, *parties cannot shorten the statute of limitations*. §431.030 R. S. Mo.

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Typical Surety Bond Issues.

HOW LONG does a claimant have to **file suit**?

In Missouri, payment bond claims would come under the breach of contract SOL – **5 years from discovery**, 516.120(1), limited by the 10 year statute of repose. 516.097. R. S. Mo.

Performance bonds are considered contracts under seal, and that statute of limitations is **ten years, period**. §516.110(1) R.S. Mo.

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Typical Surety Bond Issues.

Claims procedure

This is something that you should expect to be ***totally different from insurance to bonds***.

If a claim is valid, an **insurance company** knows that it will be paying with its own money (deductibles and co-pays aside). So you can expect sparring and negotiations right away.

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Typical Surety Bond Issues.

Claims procedure

But for a **surety bond**, the expectation of the surety is that the indemnitors on the bond (usually the owners of the contractor) will take care of the claim directly, so the surety may take a very laid-back approach.

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Typical Surety Bond Issues.

Claims procedure

As a result, the surety claim system is built, intentionally, to stall, to give the indemnitors every chance to solve their own problem – whether that is by getting a bank loan, investigating claims or going after 3rd parties. This can drag the process you are sucked into out a long time.

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Typical Surety Bond Issues.

Claims procedure

This is **very frustrating** for an owner who has had a contractor default and thinks that the surety should step up and solve the problem - ***pronto***.

Typical Surety Bond Issues.

Claims procedure

You can deal with this through bond language that demands a response within **X** days, or that the surety step in to complete the work within **Y** days..

Typical Surety Bond Issues.

Claims procedure

Of course, some sureties push back on such strict time limitations, because it doesn't take into account the fact that sometimes the surety is blindsided by the claim and can't get cooperation of the contractor – which can make it hard to respond quickly.

Typical Surety Bond Issues.

Claims procedure

But **if you have made the bond forms part of your Invitation for Bids**, so that the successful contractor has to use them, the surety may have no choice.

Typical Surety Bond Issues.

Claims procedure

Aside from strong contract language, what an owner can do is **give the surety notice early and often** of potential claims, copying it on correspondence, calling or asking for meetings – so that the surety has every opportunity to be up to speed when the time comes for you to make a specific demand.

Insurance On Construction Projects

Questions?

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Kansas City construction attorney Susan McGreevy's practice consists primarily of advising construction companies, sureties, design professionals, and owners in their day-to-day business ventures. This includes the drafting and negotiation of all types of agreements, resolution of disputes, trying lawsuits and arbitrations, strategic and succession planning, and representing sureties in bond claims and litigation as well as serving as an arbitrator and mediator.

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