Construction Industry Update

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Transferring Risk: Current Challenges

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Every firm in every business engages in contractual risk transfer. The overall objective is to shift responsibility for the risk to the party best able to control it. In an insurance context, this generally involves three parties: (1) the transferor, the party from whom risk is being transferred; (2) the transferee, the party to whom risk is being transferred, and (3) the insurance company, the party that is asked to respond to the financial consequences of the risk.

Historically, general contractors have tried to transfer as much risk as possible to their subcontractors. In some cases, this has even included the sole negligence of the general contractor, which has resulted in subcontractors bearing an unreasonably large amount of risk for construction projects.

During the current hard insurance market, prices have not only increased dramatically, but underwriters have re–evaluated the amount of risk that they're willing to assume. Many underwriters have concluded that they have been providing far broader coverage for their subcontractor clients than they had ever intended.

This problem is compounded by the fact that some insurance companies require their insureds to require of their subcontractors specific additional insured endorsements and indemnity agreements designed to transfer the maximum amount of risk allowed by law to their subcontractors. However, the insurance companies are no longer willing to provide the same coverage on the other end of the spectrum. This is creating friction within the industry. Often a general contractor will mandate insurance requirements that subcontractors simply cannot meet.

Key Areas of Friction

1. Additional Insured Status

It is not uncommon for a general contractor to require a subcontractor to provide additional insured status, not only for the insured's ongoing operations, but also for the insured's completed operations (liability arising after work has

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been completed). This is written into many subcontractor warranties.

The appropriate endorsement to provide this coverage is the Insurance Services Office (ISO) form CG2010 (11/85). This endorsement was originally published in November 1985. Basically, the CG2010 (11/85) endorsement provides additional insured status to the general contractor for any liability arising out of "your work." "Your" refers to the named insured subcontractor/transferee. The endorsement includes ongoing operations as well as completed operations.

In 1993, ISO decided that this coverage was too broad, and it revised the endorsement by restricting the additional insured status to "ongoing operations." Since 1993, the endorsement has been revised several more times to make it absolutely clear that the additional insured status pertains only to ongoing operations and not completed operations.

Nevertheless, some general contractors and developers still require the 11/85 format. Unfortunately, it has become quite difficult, if not impossible, for many contractors (especially those in the residential construction field) to comply with that requirement.

The transferor needs to remember that there are two ways to trigger coverage under a subcontractor's policy. The first is with the additional insured status, and the second is with contractual liability. In most cases, a well–written contractual risk transfer program includes both; in addition to being named as an additional insured under the subcontractor's policy, general contractors require the subcontractor to hold them harmless and indemnify them from any and all liability arising out of their operations. This would include completed operations. In other words, if general contractors can't access completed operations coverage under the additional insured endorsement, they should be able to get it under the contractual liability coverage extended through the indemnification agreement. In today's insurance environment, this may be the only alternative.

2. Manuscripted Additional Insured Endorsements

Many underwriters today do not use the ISO policy forms. Instead, they are using manuscripted additional insured endorsements in another attempt to clarify coverage. The ISO form, as currently written, has been interpreted in some situations to extend coverage to the transferor for the transferor's sole negligence so long as it arose out of the subcontractor's work. This is far broader coverage than many underwriters wish to provide. In many cases, the manuscripted endorsements will narrow coverage by specifically excluding situations, including the sole negligence of the transferor/additional insured, or even further by tying it to the subcontractor's negligence. Regardless, all additional insured endorsements should be reviewed carefully so that each party understands the coverage they are getting.

3. Primary and Non–Contributory Wording

It is common to see a requirement that subcontractors' policies be endorsed to provide evidence that their insurance is "primary and non–contributory." The purpose of these endorsements is to make certain that the subconsultant/transferee's policy will pay first, and that the transferor's policy will not come into play until the transferee's policy is exhausted. Underwriters are not always willing to add this by endorsement or to certificates of insurance, nor in most cases do they need to do so.

The "other insurance" condition of the standard ISO commercial general liability policy (CG0001) states that it is primary insurance. It goes on to say that it applies as excess over other primary insurance on which the named insured is provided additional insured status. In other words, the policy already says that the subcontractor/transferee's policy applies as primary coverage, and that the general contractor/transferor's policy is excess coverage. This meets the requirement of "primary and non–contributory."

4. Cancellation and Non–Renewal Notice Requirements

Construction contracts often require that the additional insured/transferor be given an unqualified 30 days notice of cancellation for any reason (including non–payment of premium) in many cases sent by certified mail.

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While most insurance companies will endeavor to provide ten days notice of **cancellation** for non–**payment** of premium and 30 days notice of cancellation for any other reason, they will almost without exception not provide the broader wording often required.

From the insurance companies' standpoint, this makes sense. They are in the business of providing insurance, not guaranteeing creditworthiness. If they were to allow much more than ten days notice of cancellation for non–payment of premium, by the time they could actually cancel the policy, they could be as much as 45 to 60 days into the policy period.

Insurance companies will not send notice of cancellation by certified mail either. The sheer number of certificates that an insurance company issues makes this impossible. The additional insured/transferor would be better off requiring the subcontractor to periodically confirm that coverage is in force rather than relying on an insurance company's notice of cancellation.

As an example, one insurance company we do business with does not even attempt to send notices of cancellation for policies that have lapsed. This company has found that tracking certificates of insurance is an impossible task, and it would rather take the risk of not sending the notice and fighting the odd lawsuit than incurring the expense of sending the notices. From the additional insured/transferor's standpoint, the key is to do business with solid subcontractors it knows will continue to maintain their insurance over a period of years.

5. Waivers of Subrogation

It is common for transferors to require their subcontractor/transferees to waive rights of subrogation against them for both general liability and workers compensation insurance.

Under most general liability policies, it is not necessary to specifically provide an endorsement waiving rights of subrogation. The policy itself allows the insured to waive rights of subrogation against another if it is done in writing prior to a loss. Merely including the waiver of subrogation clause in the underlying contract suffices. This is because the insurer's right to subrogate flows directly from the insured's right.

When the insured waives that right in a contract, the insurer has no right of subrogation either. Furthermore, if the transferor is also an additional insured under the commercial general liability policy, as a matter of law the insurance company will not be allowed to subrogate against its own insured.

From a workers compensation standpoint, there is usually an additional charge for a waiver of subrogation endorsement if it is even available. However, is such a waiver necessary? Consider this: the waiver of subrogation endorsement only prevents the transferee's workers compensation insurer from initiating a suit. It does not prevent the transferee's injured employee from initiating a suit, which is the more frequent cause of claims against transferors.

Secondly, even if a workers compensation insurer does subrogate against the transferor, if the transferor is held harmless and indemnified by the transferee, the risk would be transferred back to the commercial general liability policy of the transferee/indemnity (this is an exception to the contractual liability exclusion, and is thus covered by the transferee's commercial general liability policy).

In summary, waivers of subrogation applicable to both commercial general liability and workers compensation insurance are probably not as important as many people seem to believe.

Conclusion

Contractual risk transfer is a huge issue within the construction industry. Tracking certificates of insurance and making certain that each party to the transfer has held up his/her end of the deal is, in many cases, a time–consuming and impossible job. Steps can be taken, however, to simplify and improve this process:

1. **Update your insurance requirements** to reflect modern insurance technology. If your contract still has words in it like "comprehensive general liability" (a term that was last used in the insurance industry in 1973) or "broad form property damage," etc., you should consider updating your requirements.
2. **Amend your additional insured requirements** to deal with the "other insurance" issue in a manner that works with the standard industry ap-

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proach instead of requiring special language that achieves little and is difficult to obtain.

3. **Do not insist on a waiver of subrogation endorsement** on the transferee's general liability policy. Rather, include a waiver of subrogation in your primary contract.
4. Make certain that the transferee has commercial general liability coverage that is **equivalent to the ISO CG0001 policy form**.
5. **Evaluate whether or not you really need a waiver of subrogation for workers compensation**. If you decide to require it, be prepared to deal with the challenges from transferees who either can't get their insurance companies to provide it, or who will be charged an additional premium (which, ultimately, you will pay).
6. **Re–evaluate the requirement that additional insured status applies to completed operations**. Recognize that you have this coverage under the indemnity agreement, and that many of your subcontractors may not be able to obtain the additional insured endorsement you are requiring.
7. **Accept the standard insurance certificate** without modification, but do require a copy of the additional insured endorsement that adds you to the policy.
8. **Don't try to get a contractual commitment for a longer notice of cancellation than required by state law** in the event of cancellation for non–payment of premium, and don't insist on certified notice of non–renewal or cancellation.

Summary

Tracking certificates of insurance and managing contractual risk transfer is a necessary but nightmarish task. Regardless, you can take steps to make this process easier to handle and manage. By prequalifying those with whom you do business to make sure that they can be relied on to perform their contractual obligations, including buying the insurance they promise to obtain, you will go a long way toward managing this exposure.