

Risk Transfer Mechanisms for Contractors

Many firms frequently contract with other firms to provide services or perform some type of construction work. Examples range from contracting of janitorial services to installation of plumbing or better yet, complex construction of roads, bridges and buildings.

During the course of these operations, accidents may arise causing bodily injury and/or property damage to the contracting firms, their employees, contracted workers, or the public. Ideally, the liability for any accident should be transferred to the party with most control over the exposures potentially causing a loss. Owners usually try to transfer liabilities to general contractors. General contractors try to transfer liabilities to subcontractors. Subcontractors try to transfer them to sub-subcontractors, and so on.

Selecting a qualified contractor is the key to maintaining a safe job site, but accidents can happen. And in the event of such a mishap, risk transfer mechanisms can prove invaluable by reducing your chances of unknowingly taking on someone else's liability or being exposed to additional risks due to the actions or in-actions of others. These mechanisms can also allow a firm to shift its liability to another party.

This bulletin discusses the following risk transfer mechanisms:

- Certificates of Insurance
- Hold Harmless Agreements
- Additional Insured Endorsements
- Owner's and Contractor's Protective Policies (OCP)
- Waivers of Subrogation

Since individual state laws and circumstances vary, it is important that you contact your legal counsel to discuss how these risk transfer mechanisms will apply to you in specific situations.

Certificates of Insurance

Contracts can include provisions requiring subcontractors to obtain and maintain various types of insurance coverage, including workers' compensation, general liability, automobile liability and others.

A certificate of insurance is a form issued by the subcontractor's insurer (or its agent) which lists the coverage(s), expiration date(s), and limits of the subcontractor's coverage(s). The certificate may also describe special endorsements that have been added to the policy, i.e., additional insured endorsements, waiver of subrogation endorsements, special notice of cancellation endorsements, etc.

Certificates of insurance do not alter the terms or conditions of the policies described. The policies' actual terms are the ones that apply.

Prior to the commencement of the subcontractor's work, you can require proof of insurance via certificates of insurance from all subcontractors. Requesting a certificate of insurance does not, in itself, transfer any risk, but does verify the other party's types and limits of coverage.

You should consult your insurance advisor and legal counsel to determine, based on your specific circumstances, what insurance requirements are appropriate for the parties with which you contract. After reviewing the certificates, you should file them chronologically according to the soonest expiration

date shown on the certificate. Then, you can request a renewal certificate before the old coverage expires. You can also require subcontractors to give 30 days notice prior to cancellation, non-renewal or material change of coverage.

Hold Harmless Agreements

Hold harmless agreements (sometimes referred to as indemnity agreements) are used to transfer risk of loss, damage, or liability from one party to another. They are often incorporated into construction contracts, service job contracts, purchase order agreements, lease agreements, and consulting agreements.

Depending on the way that they are drafted, interpreted, and enforced, there can be great variety in the extent to which indemnity agreements transfer risk (i.e., wholly or proportionally, or not at all), what actions or inactions will trigger a transfer (i.e., your own or another party's negligent or intentional acts or omissions, or both), and the types of risk that are transferred (i.e., bodily injury, property damage, defense of claims, damages, etc.). As a result, it is important to consult your legal counsel whenever you contemplate entering into an indemnification agreement.

Additional Insured Endorsements

There are many ways owners and contractors can end up in litigation arising out of the acts or omissions of subcontractors. Therefore, owners and general contractors should consider requiring subcontractors to name them as an "additional insured on a primary, noncontributory basis" on the other party's primary commercial general liability (CGL), or any other appropriate, policy. This information should be listed as such in the comments section on the certificate of insurance.

Insurance policies can be endorsed to add companies that do business with a named insured (policyholder). A company added to a policyholder's insurance policy is considered an additional insured. The endorsement adding the company is known as an additional insured endorsement. This endorsement can complement an existing construction contract and can help protect a party from liability arising out of another party's negligence. In this way, the party named as an additional insured does not have to rely solely on the validity, effectiveness, and enforcement of the hold harmless agreement for protection. Additional insured endorsements can cover the additional insured for accidents arising out of the named insured's involvement with a job.

Additional insureds are only covered for operations involving the named insured (policyholder) in some way. In this respect, additional insureds receive narrower coverage than named insureds, since named insureds are automatically covered for any business activity not specifically excluded by the policy. Policy exclusions apply equally to named insureds and additional insureds unless specifically noted otherwise in a CGL policy or on the additional insured endorsement. You should consult your insurance advisor and legal counsel regarding the effect of any additional insured endorsements which apply to you.

Owner's and Contractor's Protective Policies (OCP)

OCP policies protect the interests of someone hiring a contractor. They are purchased by the hired contractor, but actually insure the party hiring the contractor. OCP policies show the hiring entity as

the policy's named insured. General contractors may be required to buy these policies for owners. Subcontractors may be required to buy these policies for general contractors. The hiring party is generally covered for liability arising out of acts or omissions of the contractor. In addition, the hiring party is generally covered for its general supervision of the contractor.

The coverage provided by OCP policies can be broader or narrower than some additional insured endorsements.

Even if OCP coverage is narrower, OCP policies have two advantages that might make them attractive over additional insured endorsements:

- OCP policies provide a separate limit of liability that does not have to be shared with the purchasing contractor. Additional insureds must share policy limits with the named insured.
- OCP policies are written in the name of the hiring entity, so the hiring entity will be notified if the coverage is cancelled. Additional insureds often are not notified when the policy covering them is canceled.

Waivers of Subrogation

Owners and general contractors often include waivers of subrogation in construction job contracts. The waiver gives up a contractor's right to sue the owner or general contractor in defined circumstances.

If a contractor waives its right to sue, it also affects the contractor's insurer, which might have prohibited such a waiver in the insurance policy. The insurer would have used that right to seek recovery from the responsible party for insurance claims paid to or for the contractor. Usually insurers have no independent right of their own to sue responsible parties for reimbursement of claims the insurers have paid to or for their policyholders. Insurers have to "subrogate" (take over) their policyholders' rights against wrongdoers. The process of using an insured's rights to sue a responsible party is called "subrogation."

To avoid litigation expenses down the road, beneficiaries of waivers sometimes require the waiver-giver endorse its policy with a waiver of subrogation endorsement. Such endorsements verify the waiver-giver's insurer is aware of the waiver, and will not initiate subrogation actions, while deemed waived, that are expensive to defend against.

Example: General contractor accidentally injures subcontractor, but subcontractor signed a job contract including a waiver of liability in favor of general contractor for injuries related to this job.

General Contractor: the wrongdoer (and holder of liability waiver).

Subcontractor: the innocent victim (and grantor of liability waiver).

Subcontractor, because of the liability waiver is prohibited from suing general contractor for this injury. Also, if subcontractor makes a claim to its insurer for this injury and the insurer pays it, then insurer is prohibited from suing general contractor for subrogation, i.e., reimbursement of the paid claim. In such a case, if insurer, in the insurance policy, had prohibited the liability waiver, then it might be able to rightfully deny coverage of subcontractor's claim for the injury.

Conclusion

Risk transfer mechanisms are an important part of any risk management program. They allow a firm to minimize its chances of unknowingly taking on someone else's liability or being exposed to additional liabilities due the actions of others and also to shift liability to another party. Let us review some considerations owners and contractors should take into account when dealing with risk transfer mechanisms.

When accepting liability, i.e., a sub-subcontractor accepting liability from a subcontractor, a subcontractor accepting liability from a general contractor, or a general contractor accepting liability from an owner:

- Pay special attention to the operations of the other party (the party held harmless) or additional insured. What potential claims may arise from their operations? What type of liability may be assumed?
- Review contract language with legal counsel to determine the extent and effectiveness of hold harmless protection requested, if any. If possible and appropriate, negotiate to reduce the extent of liability you assume. Balance the value of the job against the risk posed by the assumption of liability in the contract.
- Review contract language with legal counsel and insurance advisor to determine the presence and extent of mandated coverages not provided by your current policies. Uninsured commitments could expose you to breach of contract suits and financial liability. (Breach of contract suits are not necessarily covered by contractual liability insurance).
- When affording an entity additional insured status, do not provide more coverage than intended. Consult your legal counsel and insurance advisor to make sure that coverage obtained is appropriate to your circumstances.
- Do not grant waivers of subrogation freely. Consult your legal counsel and insurance advisor regarding your own insurance obligations. If confronted with a choice between waiving subrogation or losing a job, balance the value of the job against the risk assumed by signing the waiver.

When transferring liability, i.e., a general contractor transferring liability to a subcontractor, or an owner transferring liability to a general contractor:

- Ensure hold harmless agreements (indemnity agreements) appropriately protect you under the circumstances. Consult competent legal counsel.
- Consider requiring additional insured endorsements to the other party's appropriate insurance policies to supplement any contractual risk transfer protections.
- Request any appropriate certificates of insurance from the other party to verify the insurance coverage(s) in force.
- Request a copy of the additional insured endorsement to determine if your company is named as an additional insured on the other party's general liability policy and, if so, on what basis.
- Ensure the protections you require from others are appropriate to your circumstances. Consult your legal counsel and insurance advisor.