Avoiding Common Subcontractor Insurance Pitfalls

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WHETHER RESIDENTIAL OR COMMERCIAL, NEARLY EVERY CONSTRUCTION project today requires the use of subcontractors. While contractors often devote a good deal of effort and attention to their prime contracts with a project owner, subcontracts can be an afterthought. This can be a problem when it comes to insurance requirements. Too often, contractors rely on poorly worded or outdated forms or templates that do not align with the insurance requirements of their prime contracts. When things do not go smoothly on the construction site, this can lead to large claims with limited or no insurance coverage. With a better understanding of the insurance provisions of their subcontracts, contractors can better manage risk and prevent possible issues before losses occur.

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THE BASICS OF RISK TRANSFER

The goal of risk management in construction contracts is to transfer risk to the party that is closest to it and therefore best able to manage it and control losses. On the construction site, this often means subcontractors. Thus, project owners will push risk downstream to general contractors, who will, in turn, push the risk down to their subcontractors.

The two key methods of risk transfer in construction contracts are indemnity and insurance provisions. Indemnity provisions typically require the downstream party to pay for the liability (and often the defense) of the upstream party. Insurance provisions typically require the downstream party to purchase insurance covering itself and the upstream party, which is generally accomplished through "additional insured" coverage. As an additional insured, the upstream party is entitled to defense and indemnity for claims related to the downstream contractor's work. When done properly, the downstream contractor's insurer assumes some of the risk of losses related to the work.

Indemnity and insurance provisions in construction contracts are complementary as each is intended to protect the contractor and other upstream parties from losses related to the subcontractor's work. Many contractors mistakenly assume, however, that because they have an indemnity provision covering certain liabilities in their subcontract, they will also have coverage under their subcontractor's insurance policies for those liabilities. That is not always the case. Indemnity and insurance are separate and distinct forms of risk transfer. The scope of insurance coverage is defined by the subcontractor's insurance policy—in particular, the additional insured endorsement attached to its policy—not the indemnity provisions of the subcontract.

SCOPE OF ADDITIONAL INSURED COVERAGE

There are two basic types of additional insured endorsements: a broad "arising out of" endorsement and a narrower "caused, in whole or in part, by" endorsement. Both afford coverage to the upstream contractor for claims related to the subcontractor's work, but they are not the same. The "arising out of" endorsement has been held by many courts to cover the additional insured for its own liability—even its sole negligence—so long as the liability is related in some way to the subcontractor's work. In contrast, the "caused, in whole or in part, by" endorsement typically has been held to cover the additional insured for its partial negligence, provided the subcontractor is also at least partially at fault.

Thus, contractors and other upstream parties are more protected when they require subcontractors to obtain a broad "arising out of" additional insured endorsement. However, not all subcontractors will be able to obtain such an endorsement, as it is now standard for insurers to issue the narrower "caused, in whole or in part, by" endorsement.

TRIGGERING ADDITIONAL INSURED COVERAGE

Additional insured endorsements can take several forms. The first is a scheduled endorsement that specifically identifies the entity or entities that are additional insureds. More commonly, however, subcontractors will rely on blanket additional insured endorsements, which automatically confer additional insured status on certain entities when specific requirements are met. Typical blanket additional insured endorsements require that the named insured (i.e., the subcontractor) agree in a written contract or agreement to include the upstream party as an additional insured under the policy.

One pitfall is not clearly including the additional insured requirement in subcontracts. Many subcontracts will specify that the subcontractor provide certificates of insurance verifying that the contractor (and potentially others) are additional insureds. While some courts have held this is sufficient to trigger coverage under a blanket additional insured endorsement, the better practice is to be specific and require that the subcontractor must add the contractor as an additional insured. Upstream parties also should identify all of the policies on which they are to be included as an additional insured. Typically, this would include all policies except professional, technology errors and omissions, workers compensation, and employer's liability.

Some blanket additional insured endorsements require that the written contract be between the named insured and the additional insured (in legal terms, this is referred to as privity of contract). For the upstream party, this is often not a problem as the contractor will have entered into a written subcontract that requires that the contractor be included as an additional insured. Many prime contracts, however, require that the upstream party (e.g., the contractor) ensure that entities farther upstream (e.g., the project owner) and potentially other parties also be included as additional insureds on policies issued to the subcontractor. If the additional insured endorsement on the subcontractor's policy requires that the subcontractor be in contractual privity with the additional insured, then the project owner may not be an additional insured, even if the contractor requires it in its subcontract. Thus, it is important that the contractor review a copy of the actual additional insured endorsement the subcontractor is using to ensure that it covers all of the required parties.

ANTI-INDEMNITY/INSURANCE LAWS

Many states have laws limiting the extent to which one party can indemnify another in a construction contract. For example, some states prevent a contractor from requiring its subcontractors to indemnify the contractor for its own negligence. Other states prohibit contracts that require one party to purchase insurance covering the other party for its own negligence. Since the scope and application of these laws varies from state to state, it is important for contractors to be aware of the state law applicable to their subcontracts. In addition, consider including language in subcontracts providing that, if the insurance requirements run afoul of applicable anti-indemnity/insurance laws, they should still be enforced to the fullest extent permitted by law. This may prevent a court from striking down the offending insurance requirement in its entirety and instead enforcing it in a more limited way in accordance with state law.

FLOW-DOWN REQUIREMENTS

Prime contracts commonly require that the contractor demand its subcontractors procure and maintain the same types and limits of insurance that the contractor is required to procure and maintain. A failure to comply with this provision could result in the contractor being exposed to a claim for breach of contract. Contractors should ensure that their subcontracts incorporate the insurance requirements of the prime contract, and confirm that the subcontractors are in compliance with those requirements.

In drafting subcontracts, a good practice is to include a requirement that the subcontractor (and any sub-subcontractors) procure and maintain, in addition to the specified insurance, any other insurance as required in the prime contract. However, the subcontractor or their subcontractors may not have access to the prime contract (for example, if there are confidentiality provisions) or the contractor may neglect to provide the subcontractor with the insurance requirements of the prime contract. Thus, including a boilerplate provision like this should not be a substitute for the contractor carefully reviewing the insurance requirements of the prime contract and specifically identifying any required coverages in its subcontracts.

WAIVERS OF SUBROGATION

Subrogation is the right of an insurer that has paid a claim to step into the shoes of its insured and assert claims against another party to recover some or all of the amount it paid to its insured. Construction contracts often contain waiver of subrogation provisions to prevent an insurer from recouping its payment on a claim from the upstream party.

Policies issued to subcontractors typically contain a blanket waiver of subrogation endorsement, which permits the subcontractor to waive the insurer's subrogation rights, if done in a written contract prior to the loss. Some endorsements, however, require that the subcontractor waive its own right of recovery in order for the insurer to waive its right of subrogation. Thus, consider including language requiring that the subcontractor waive its own right of recovery to the extent of loss that is covered by insurance.

Prime contracts also may require that any subcontractors waive their (or their insurer's) subrogation rights against the owner. Contractors should ensure that their subcontracts reflect the subrogation waiver requirements in their prime contracts. As with additional insured endorsements, however, some blanket waiver of subrogation endorsements require that the named insured be in contractual privity with the party against whom it is waiving subrogation rights. Thus, it is important for contractors to review a copy of the subcontractor's waiver of subrogation endorsement in order to ensure that the subcontractor and contractor are in compliance with their contractual obligations.

ACCESS TO THE SUBCONTRACTOR'S FULL LIMITS

The 2013 ISO additional insured endorsements contained language restricting additional insureds to only those limits that were agreed upon in the contract with the named insured. Specifically, the 2013 ISO forms state, "If coverage provided to the additional insured is required by contract or agreement, the most we will pay on behalf of the additional insured is the amount of insurance…required by the contract or agreement."

Thus, if a subcontractor has a policy with $2 million in limits, but the subcontract only calls for $1 million, the contractor would only be entitled to $1 million as an additional insured under the subcontractor's policy. As a result, contractors might consider including language in their subcontracts providing that the specified limits are only minimums and that, if the subcontractor obtains a policy with limits greater than the specified minimums, the contractor is entitled to the full limits of the policy as an additional insured.

INSURANCE FROM SUB-SUBCONTRACTORS

If a subcontractor will be using subcontractors of its own for some or all of the work, it is important to ensure that the subcontractor requires appropriate insurance from them. This is particularly important with additional insured and waiver of subrogation requirements because, as discussed earlier, many blanket endorsements require contractual privity. Since a contractor will not be in contractual privity with the sub-subcontractor, it is important for contractors to require sufficient proof of insurance from not only their subcontractors, but also from any sub-subcontractors being used.

PROOF OF INSURANCE

Subcontracts typically require the subcontractor to provide some proof that it has the required insurance, usually in the form of certificates of insurance (COI). While COIs may give a contractor some comfort, they are not a guarantee that the subcontractor has actually met its insurance requirements. In fact, the standard ACORD certificate of liability insurance expressly states that it confers no rights on the certificate holder and does not amend, extend or alter the coverage afforded by the insurance policies themselves.

For example, if a contractor requires that its subcontractor name the contractor and the owner as an additional insured on its CGL policy, a COI might list the contractor and owner as

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additional insureds. But if the actual additional insured endorsement attached to the subcontractor's policy requires contractual privity with an additional insured, the owner would not be an additional insured, notwithstanding what the COI says.

A better practice is to request, in addition to COIs, copies of the actual endorsements the contractor is requesting. Of course, the most protective practice would be to request a copy of the subcontractor's entire policy. Often, however, contractors do not have the time to do a complete review of their subcontractor's full policies to confirm compliance. Requesting copies of the relevant endorsements provides a good middle ground between ensuring compliance and efficiency.

One danger of requesting copies of endorsements or policies, however, is that the subcontractor could argue that the contractor waived any non-compliance with the insurance requirements by failing to object after it received those documents. To prevent such an argument, the subcontract could include language stating that the contractor is not waiving any failure of the subcontractor to procure the required insurance by requiring the subcontractor to provide evidence of insurance. ■

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