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Managing Risk: Insurance and Indemnity Clauses in Construction Contracts

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This paper is directed almost exclusively at risk-shifting clauses in construction contracts. Any discussion of construction contract clauses and their interpretation has to begin and end with two very basic common-sense principles.

The first principle is that companies involved in the construction industry must exercise care in the selection of customers, the acceptance of work, and in the nurturing of customer relationships. The contract clauses discussed in this paper are enforceable. However, the cost to enforce these clauses against a customer, general contractor or subcontractor with whom one never should have contracted in the first place can be prohibitive!

Secondly, "THINK BEFORE YOU INK!" Some contractors do not read or understand the terms of the contracts they sign. Hopefully you are one who does not fall into that trap!

CONTRACT ESSENTIALS

Most contracts consist of an offer and an acceptance. Contracts do not have to be in writing, unless the contract is incapable of being performed in one year. The problem with oral contracts is that it is hard to prove contract terms when they are not written down.

Some contracts that you might not have thought were written actually are. For example, you could respond to a request for proposal by submitting a bid. The request for proposal is clear with regard to what has to be done and does not require you to execute a written subcontract agreement. You submit your bid under that proposal and include your standard-form terms and conditions. The customer writes back and accepts your bid, with subcontract negotiations to follow.

In the interim, the customer sends you a notice that directs you to order steel, prepare and submit shop draw-

ings, and begin the buy-out and fabrication process to meet the project schedule. If you proceed, and if you change your economic position (i.e., spend your own money, devote detailing and shop time, etc.) then you have a contract. The terms of the contract are the original request for proposal, your bid, and any additional terms and conditions in the notice to proceed, which you accepted.

It is better to have a formal written subcontract that is fully negotiated. But the law does not require this. On some public works projects, if you are the low bidder, and are an otherwise responsive and responsible bidder, a general contractor might not even have the ability to refuse to award you the work based on the fact that you will not agree to its standard-form subcontract.

There has to be a clear offer and clear acceptance for there to be a contract; the receipt of a notice to proceed could be enough if you change your economic position as a result; and you do not have to execute a standard-form contract unless you were notified of its provisions in the documents upon which you formulated your bid.

Some subcontracts contain a clause that says that your bid has been superseded by subcontract terms, no longer forms a part of your contract, and has no legal effect. If you are asked to sign such a contract, strike it or ascertain that all of the terms of your bid are included in the final subcontract.

STANDARD FORM CLAUSES

It is advantageous for subcontractors to use the standard-form language contained in the AIA contract documents. These documents address the interests of subcontractors in as fair a manner as any standard-form construction contract documents in the industry, and are better than comparable forms prepared by general contractor groups. They are widely used and rec-

ognized, and near to an industry standard. As such, they are an easier sell to an upstream contractor or owner than a document prepared by your company or trade association lawyer.

Further the 2000 AISC *Code of Standard Practice* should also be incorporated. It is an industry consensus document and it establishes standard practice in the U.S. fabricated structural steel industry. It is the basis upon which knowledgeable bids should be made and received, and it fills gaps in areas of custom and usage that no standard-form construction contract or specification covers.

It has been endorsed by the Coalition of American Structural Engineers, the American Institute of Architects, and the independent "MasterSpec" publication. It also has been endorsed by use in standard-form guide specifications issued by the General Services Administration, the U.S. Army Corps of Engineers, and other large public owners.

THE GOLDEN RULES OF RISK MANAGEMENT

1. The entity that is in the best position to control the risk should take responsibility for the risk.
2. If possible, risks that cannot be controlled should be transferred to someone else.
3. Risks that cannot be controlled and cannot be transferred to someone else should be insured.

Risks are shifted to another party through indemnification agreements or indemnification clauses in construction contracts. Insurance policies are contracts between the insurance carrier and the insured. Insurance requirements for individual construction projects are set out in the insurance clauses in the project construction contract. Not all indemnification clauses and insurance clauses in construction contracts are alike; and not all insurance policies are alike.

INDEMNIFICATION

The Golden Rule of indemnification clauses is:

- If you agreed to it, then you are going to have to do it; and,
- If you agreed to do too much, you might not have insurance to cover it.

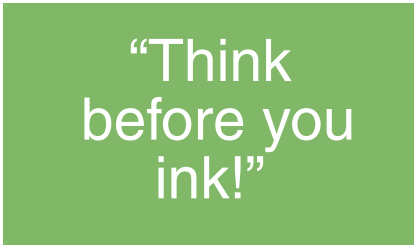
Except in special, narrowly defined situations, most courts will enforce indemnity clauses as they are written.

The insurance industry essentially delineates between two types of contracts: There are "insured" contracts, and there is everything else.

Customary risks that are part of normal business transactions in a particular industry will be covered if the obligations which give risk do not stray too far from insurance companies' template for that industry.

Indemnification clauses and design responsibility clauses are the primary areas of construction contracts where a fabricator is at greatest danger of exceeding the carrier's notion of an "insured contract" and losing coverage.

In general, indemnification clauses should be mutual in nature (they should apply equally to both parties). One party should not escape liability arising from its own negligence at the expense of another party that is without negli-



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gence; and one party should not be asked to undertake a risk that another party is in a better position to control.

The standard indemnity clause that appears in AIA Document A401-1997, *Contractor-Subcontractor Agreement*, is an indemnification clause that has been generally accepted by the insurance industry. Indemnification provisions in steel fabricators' construction contracts should not stray too far from this norm.

INSURANCE

If you cannot control a risk through your business practices or transfer that risk to someone else through an indemnification clause, then you can manage that risk through insurance. In general, most insurance companies participate in an organization called the "Insurance Services Organization" (ISO) that has developed standard form, suggested clauses for individual insurance carriers to utilize in their insurance contracts. Many carriers follow the ISO forms closely, but strict compliance is not required nor practiced. Also, many companies issue exceptions or exclusions on individual policies.

Some standard pieces of advice for clients in the fabricated structural steel industry: take time to review the terms of all policies with an insurance broker or agent; and confirm that the insurance required by individual construction contracts will be provided for all risks assumed.

In addition to coverage for normal business risks, risks of delegation of design responsibility and involvement in design-build projects might not be covered under "Insurance Contracts" indemnification clauses.

Most contract risks assumed by fabrication and construction businesses are covered by Commercial General Liability ("CGL") insurance policies. Most risks assumed by design professionals are covered by a "professional liability" or "errors and omissions" ("E&O") insurance policy. Standard ISO CGL forms exclude coverage for professional design services. Standard ISO E&O forms exclude coverage for construction work.

The author has seen instances where design professionals and construction contractors have entered into a design-build venture together, and later discovered that each had inadvertently waived their individual coverage and that their combined work was not protected by insurance. The insurance industry has evolved since this occurred, but all parties should enter into design-build arrangements with a clear understanding of coverage issues.

There are essentially four insurance products that are applicable to a fabricator's normal business operations: workers' compensation insurance, automobile insurance, CGL insurance, and builders' risk insurance. A fifth, E&O insurance, could be applicable where design responsibility is assumed. Workers' compensation coverage varies from state to state and is applicable to all employers doing business in a particular state, as is automobile insurance.

CGL POLICY COVERAGE

CGL policies provide insurance coverage for owners, developers and contractors in three major areas: 1. bodily injury and property damage; 2. personal and advertising injury liability; and 3. medical payments. The majority of CGL policies are "occurrence" policies: Claims can be filed for incidents of

bodily injury or property damage that resulted from an occurrence during the policy period. The coverage and exclusions discussed below apply to normal fabrication operations.

CGL MEDICAL PAYMENT COVERAGE

This coverage reimburses medical expenses incurred by persons injured on the contractor's premises or because of the contractor's operations, without regard for legal liability for those injuries. The insurer will pay for all reasonable expenses incurred within a year of the injury on a "no-fault" basis for injuries compensable under the policy. These payments are designed to decrease the number of claims filed under the "Bodily Injury" policy coverage.

CGL SUPPLEMENTARY PAYMENTS

This coverage addresses expenses associated with investigating and defending against liability claims covered by the CGL policy. It covers investigative and legal expenses incurred by the contractor at the insurer's request, pre-judgment interest awarded against the insured, and interest on judgments that accrue after the judgment but before the insurer pays the claim. Supplementary payments do not reduce or otherwise affect policy limits.

ADDITIONAL INSURED

The insurer has the positive duty to defend additional insureds when the following conditions are met:

- The insured contractor has specifically agreed in an "insured contract" to assume the indemnitee's defense or defense costs.
- The liability for bodily injury and property damage assumed by the insured in the indemnity agreement must be a kind covered by the policy.
- The contractor and its indemnitees are both named in the suit.
- There is no apparent conflict of interest between the contractor and its indemnitee.
- The request for a defense is made by both the insured and the indemnitee, and both parties consent to the assignment of the same counsel to defend both parties.
- The indemnitee agrees to cooperate with the insurer in defending the suit (just as the insured agrees to do

in the policy's basic conditions) and to provide records and documents related to the suit.

- The indemnitee must agree to notify any other insurer whose coverage is available to the indemnitee and to cooperate in coordinating such other coverage.

EMPLOYERS LIABILITY EXCLUSIONS

This provision excludes from CGL coverage bodily injuries that employees of the contractor suffer as a result of their employment. Also excluded are consequential damages claimed by employees' family members. These claims are assumed to be covered by workers' compensation insurance.

POLLUTION EXCLUSION

The pollution exclusion excludes property damage arising from the "discharge, dispersal, seepage, migration, release or escape of pollutants" from coverage. There is an exception about transporting pollutants to the site for gas, fuel and other substances relating to the operation of machinery, but only if the discharge is accidental.

AIRCRAFT, AUTOMOBILE, AND WATERCRAFT EXCLUSION

This exclusion precludes coverage for bodily injury and property damage arising from the ownership, maintenance, use (including operation and loading and unloading), or entrustment to others of aircraft, automobiles, or watercraft. Liability arising from damages arising from aircraft, watercraft and autos not owned, rented or loaned by the contractor (e.g. those of subcontractors) is an exception and is covered.

It is assumed that coverage for automobile liability will be covered by a separate business auto policy. Because of the overlap between automobile use, which is excluded, and the use of certain mobile machinery, which is included, it is recommended that contractors obtain their CGL policy and business auto policy from the same source.

MOBILE EQUIPMENT TRANSPORTATION EXCLUSION

Bodily injury and property damage arising from the transportation of mobile equipment by vehicle is not covered. There is an exception to the

exclusion where an independent subcontractor performs transportation.

DAMAGE TO PROPERTY EXCLUSION

This provision excludes coverage for property damage to owned, rented, leased or alienated premises, personal property in the contractor's care, custody or control, and to some extent the contractor's work. It is effective for the time period while the contractor's work is in progress. Potential problems in interpretation arise because most contractors purchase and "own" most building materials going into projects, and are considered "owners" until such time as ownership is transferred to the project owner. Contractors receive maximum protection under this exclusion by incorporating a provision into their construction contracts that transfers materials to the owner upon incorporation into the project or upon payment to the contractor, whichever occurs first.

This exclusion also precludes coverage for equipment and tools borrowed by the contractor and for heavy equipment in the contractor's control, such as that moved by cranes.

Finally, the provision excludes from coverage damage to "that particular part of real property" on which work is being performed at the time of the loss, and the repair, replacement or restoration needed because the work was incorrectly performed. That language is meant to define resulting damage to other work already in place as being covered, while precluding reimbursement for faulty work or for the item on which work is being performed at the time of the loss. Unfortunately, it is difficult to draw the line precisely between what is being worked on and what is already completed work.

THE "DAMAGE TO YOUR WORK" EXCLUSION

This provision precludes coverage for damage to the contractor's completed work arising as a result of the contractor's negligence or some defect in the contractor's completed work. By specific exception, this section does not apply to damage to the work of the insured's subcontractors or damage arising from the work of the insured's subcontractors.

IMPAIRED PROPERTY EXCLUSION

This exclusion precludes coverage for damages arising in property not physically injured (impaired property) arising from a defect, deficiency, inadequacy or dangerous condition in the contractor's (or subcontractor's) work, or by a delay or failure of the contractor to perform his contractual obligations. This is to preclude from coverage certain business risks not resulting in property damage or bodily injury but arising from the insured's failure to perform contractual duties, including the duty to perform work in a workmanlike manner.

This provision does not preclude coverage for the loss of undamaged property arising from a sudden and accidental injury to the contractor's completed work. It does preclude coverage for damage that can be repaired by repair or replacement of the defective work. However, there is a gray area in the coverage concerning defective work that cannot be replaced or repaired. This exclusion does not apply to sudden and accidental loss of the contractor's work after it has been put to its intended use.

BUILDERS RISK INSURANCE

Builders risk policies protect the named insured (generally the contractor/fabricator and owner) against the eventuality that property, specifically the building undergoing construction or renovation, is damaged by a named peril during the course of construction. Under common law, the contractor was liable for any damages that occurred to the property while construction was underway; specifically, the contractor was liable to produce the results for which he had contracted, at the contracted price, irrespective of the value of lost work already provided.

In general, construction contracts specify that the owner or the general contractor must purchase a builders risk policy that names the owner, the general contractor, and the subcontractors as insureds. In some instances it is appropriate for a fabricator to purchase builders risk insurance if not covered by other insurance applicable to the project work.

Builders risk policies come in two general types: all risk policies and named peril policies. Named peril poli-

cies are narrower in scope than all risk policies, and provide coverage only if a specified event results in property damage. All risk policies are more inclusive, but are usually limited by named exclusions. Additionally, no builders risk policy covers non-fortuitous loss, which is generally defined as an intended loss or a loss over which the insured had control. Finally, a loss must be physical damage to property in order to be covered.

Included in most policies is coverage for loss or damage to the property of others for which the contractor could be liable. This coverage is especially important as most commercial general liability (CGL) policies have a specific exclusion for care, custody and control that could eliminate coverage under the owner or contractor's CGL policy.

Some builders risk policies provide coverage only while the covered property is within a certain distance of the construction site, usually 100'. However, other policies offer protection for property in transit and stored temporarily at off-site locations. Even policies that cover transit restrict transport over water from coverage. Most policies contain a specific list of property excluded from coverage, such as automobiles, aircraft, trailers and watercraft; contractor's tools, equipment and machinery not destined to become part of the structure; trees, grass, shrubbery and plants; and accounts, bills, currency, money, and securities. Insureds generally can negotiate necessary exceptions to the exclusions.

Most builders risk policies allow insureds to waive, in writing, their right of recovery against other named insureds prior to the occurrence of any loss. Many standard construction contracts include a mutual subrogation provision. If using a contract with a standard mutual subrogation clause, it is imperative that the insureds ascertain that the builders risk policy allows such subrogation. Otherwise, the insureds might be in violation of the policy, which could bar recovery on a claim.

DESIGN RESPONSIBILITY

In the two decades since the Kansas City Hyatt Regency Skywalk Collapse, no topic has been as heatedly discussed as the assumption of responsibility for connection design by structural steel fabricators. As a result, the status of the

law in this area has advanced and fabricators now are in a better position to evaluate risks involved.

Most fabricators are faced with three types of contract clauses related to the process of selecting, detailing, and fabricating connections:

1. The "traditional" condition: the project engineer of record either **a)** fully designs the connections as part of preparation of the contract documents or **b)** specifies the types of connections desired that the fabricator's detailer will further develop through shop drawing submittal. The project engineer of record will review and approve, or take other appropriate action on, these submittals.

2. Clauses where the project engineer of record specifies desired connections and related performance criteria; and that the actual work of developing the connections is to be performed by or under the supervision of a licensed professional engineer. Sometimes the word "design" appears in this clause or a fabricator's professional engineer is instructed to apply a professional seal to the submittals. The project engineer of record will review and approve, or take other appropriate action on, these submittals. The legal implication is essentially the same as the legal implication of the "traditional" approach.

3. The fabricator is directed to provide a licensed engineer to assume legal responsibility for connection design, and/or indemnify the project engineer of record from the legal consequences of that design, and/or, either expressly or by implication, become the "engineer of record for the connections."

An important insurance question is whether the above scenarios fall within the insurance company's notion of a normal contract risk in the fabricated structural steel industry. There is currently no industry-sponsored CGL policy that provides a clear answer to this question.¹ Because of this, fabricators should discuss their policies with their insurance carriers to assure, in writing, that coverage is in place for whichever risks are assumed.

The predominant view among most fabricators appears to be that Situation 1 would be covered by the fabricator's CGL policy and that Situation 3 probably would not.

So if you plan to enter into contracts characterized by the third example, then you will probably need to purchase the type of errors and omissions insurance coverage normally provided to engineering firms. You probably should purchase this insurance from the same company that provides your CGL coverage, to prevent gaps in coverage.

If you can't get this coverage, perhaps you don't need to sign these types of contracts. You should express concern to the owner/general contractor/construction manager: If this coverage is not available to you, it might not be available to others in the industry. Design team members could lose their coverage if a fabricator that has not checked its coverage carefully is contracted and there is a connection failure.

In the second example, the issue is whether your insurance carrier, or a court interpreting your CGL insurance contract, will agree that this example is one of the industry's "insured contract" risks.

One case that supports the argument that your CGL policy should provide coverage for Example 2 is the

decision of the Supreme Court of New York in the matter of *General Building Contractors of New York State v. New York State Education Department*². The State of New York enacted a regulation defining the terms under which delegation of limited design work can be delegated to an engineer retained by a construction contractor.

Both the New York regulation and the AIA General Conditions require the project engineer of record to specify performance criteria to be followed in the delegated design, and require the project engineer of record to review and approve, or take other appropriate action on, submittals involving the delegated design.

The rationale provided by the General Building Contractor's case in New York supports fabricators and their attorneys in both initial coverage negotiations and after-the-fact litigations with insurance carriers. The AISC 2000 *Code of Standard Practice* does not provide standard practice for utilization of a licensed professional engineer to prepare shop drawings. Provisions of the 2000 *Code* that address the issue of connection design and submittal review

recognize standard of practice in the industry to include review and approval of shop drawing submittals by the project engineer of record. The standard practice is the same regardless of whether the submittals are prepared by an unlicensed detailer or a licensed professional engineer.

However, the legal situation changes when the fabricator moves into the role of "engineer of record for connections" or is required to indemnify the project engineer of record from liability for connection design. This is a situation that has not been addressed by any known court decision and it should be approached with extreme caution.★

NOTES

¹AISC is in the process of investigating formation of a captive insurance company that would provide clarity to this question.

²For future reference by your lawyer, this case is recorded at 175 MISC. 2d 922; 670 N.Y.2d 697; 1997 N.Y. Misc., LEXUS 683 (1997).