

# **INSURANCE TRAPS FOR CONTRACTORS ON CONSTRUCTION PROJECTS: HOW TO RECOGNIZE AND AVOID THEM**

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Everyone is busy in the construction business. Between bidding, scheduling, and completing work, contractors are always in motion. Throughout this process, contractors tend to focus on what they do best – building things. Today, however, a contractor must also understand the insurance component of its work to protect its business. This includes recognizing and avoiding construction project insurance traps. We discuss below strategies to assist with this.

## **PART I**

### **RECOGNIZING CONTRACTOR INSURANCE TRAPS**

#### **Coverage Trap 1 – Illusory Coverage – “You have insurance for this job but no coverage”**

As illogical as it may seem, insurance companies have issued a policy to a contractor for a particular job (or geographic area), but then added endorsements or exclusions to the policy limiting or eliminating coverage for that job or area. In such a case, a contractor that pays the premium for the policy, and receives the actual policy, believes that it has coverage protecting its workers and business from bodily injury or property damage claims. However, if an incident occurs, and the contractor tenders the claim to the insurance company, the contractor may find that it has purchased the illusion of coverage, and nothing else. In such cases, the contractor may be faced with an uncovered claim.

A case illustrating the point is *720-730 Fort Washington Ave. Owners Corp. v. Utica Fort. Ins. Co.*<sup>3</sup> Builder-owner 720-730 Fort Washington Ave. Owners Corp. (“Fort Washington”) hired general contractor DNA Contracting (“DNA”) to renovate Fort Washington’s building. DNA in turn hired subcontractor Rauman Construction Company (“Rauman”) to perform masonry and roofing work for the project.

The contract between DNA and Rauman required Rauman, as the subcontractor, to purchase Commercial General Liability (“CGL”) coverage that included DNA and Fort Washington as Additional Insureds.<sup>4</sup> Rauman purchased such a policy. However, buried in that CGL policy were three exclusions that took this protection away from Fort Washington and DNA. First, the CGL policy did not cover bodily injury for any employee of Rauman injured in the course of the project work. Second, the CGL policy excluded coverage for “roofing work,” and third, the CGL policy excluded coverage for liability assumed under a contract. No one at Fort Washington apparently understood that the CGL policy excluded the risks that Fort Washington thought were covered.

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<sup>3</sup> 26 Misc.3d 503, 893 N.Y.S.2d 426 (Sup. Ct. Bronx County 2009).

<sup>4</sup> *Id.* at 504-505.

During the project, Rauman employee Marcos Castellon suffered an onsite injury, allegedly from a falling concrete block. He brought suit in the Bronx County Supreme Court against Fort Washington as owner of the property. Mr. Castellon alleged that the concrete block fell on him because it was not adequately secured in violation of Labor Law §§200, 240(1) and 241(6). He could not sue Rauman, his employer, because workers compensation, his exclusive remedy against Rauman, barred such a claim.

Upon receiving the suit papers, Fort Washington demanded coverage for the loss under Rauman's CGL policy naming it as an additional insured. Rauman's CGL insurer, Utica First Ins. Co. ("Utica First"), denied Fort Washington coverage based on the three exclusions cited above.

Fort Washington sued Utica First. It claimed that Utica First had issued a worthless, misleading policy excluding the risks that it had been purchased to cover, and that public policy required that coverage be provided as intended. The Bronx County Supreme Court agreed that the policy was worthless and misleading, but still found against Fort Washington. It held that parties to an insurance contract chart their own course in their agreements. The buyer had to beware. There was no law or statute that required that First Utica provide a minimal level of coverage.

Thus, Fort Washington should have confirmed that the CGL policy its contractors and subcontractors provided for the job contained adequate coverage and protection. It did not, however, conduct this due diligence, so the fault lay squarely on its shoulders.<sup>5</sup> Rauman had no assets to speak of, so DNA and its insurance carrier were left to pay the claim. DNA had indemnified Fort Washington against such claims and had purchased proper CGL coverage for such a loss.

The *Fort Washington* case is uncommon, but not unique.<sup>6</sup> It demonstrates why the illusory coverage trap exists: contractors generally do not expect that a policy would exclude the coverage that they purchased it to provide. As a result, they may accept the policy without recognizing the danger, and start work without adequate coverage. Knowledge comes only after an injury or property damage on a construction project with the resulting claim and denial. By then, it may be too late for the contractor.

### **Coverage Trap 2 – Not understanding the policy exclusions, endorsements, and insuring agreements limiting or eliminating insurance coverage**

A similar issue arises when a contractor receives the policy that it expected, but does not understand that the "standard policy" purchased does not cover the intended risk. In this case, there is nothing misleading about the policy. The coverage trap exists because of the disconnect between what the insurer has covered, and what the contractor believes the insurer has covered.

The disconnect exists because the contractor does not understand the terms and limitations of the insurance policy. A contractor's insurance policy contains many pages of fine print. Judges – no strangers to fine print – have thrown their hands up at the unintelligible drafting of some insurance contracts. Yes, it is hard to review insurance contracts. But without understanding them, including

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<sup>5</sup> *Id.* at 512-513.

<sup>6</sup> See *Littlejohn v. Dominos Pizza LLC*, 130 A.D.3d 500, 14 N.Y.S.3d 13 (1<sup>st</sup> Dep't 2015) (remarking that a deductible equal to its coverage limit rendered a primary liability policy purchased by a tenant illusory).

their coverage limitations and exclusions, the contractor cannot know if it has the coverage it paid for.

For example, the standard CGL policy may exclude or limit coverage for pollution related damages or damages associated with a contractor's excavation, collapse and underground related operations. Coverage may also be limited for claims related to the contractor's own work, for work performed on residential homes, or for work performed by a contractor's downstream contractors. A CGL policy may also exclude claims alleging sexual harassment, discrimination, workplace errors, intentional acts, or punitive damages. Policies also may not cover liquidated or consequential damages, or limit such coverage.

A case on point illustrating how policy exclusions and insuring agreements can impact a project is *Lend Lease (US) Constr. LMB Inc. v. Zurich Am. Ins. Co.*, in which responsibility for a construction project loss turned on exclusions and insuring agreements in a builders risk insurance policy.<sup>7</sup> During Hurricane Sandy, high winds partially toppled a 750 foot tower crane on the 20<sup>th</sup> floor of a hotel under construction in Manhattan. The owner and construction manager claimed that damage to the building and the crane should be covered because the crane was "temporary work" under the policy. The policy, however, excluded coverage for the contractor's tools, machinery, plant and equipment. The builders risk carrier disclaimed coverage for the dollar loss, and the parties headed to court. The appellate court held that the crane was not "temporary work" under the policy and that it was part of the contractor's tools, machinery and equipment. As a result, the owner and construction manager, under the builders risk policy, were denied coverage for a \$6.9 million loss.

The appellate court observed that the owner or construction manager could have sought a policy endorsement covering the 750 foot crane tower.<sup>8</sup>

If this coverage trap can trip up sophisticated parties to a multi-million dollar contract, it can happen on any project. We discuss below how to avoid this trap.

### **Coverage Trap 3 – Not understanding the indemnity and insurance requirements of the contract**

There are two critical elements to a construction contract that a contractor must review and understand: the indemnities that run to the owner as the upstream party from the contractor, and the insurance that the contractor has agreed to provide to benefit the owner.

#### **a. The contractor's indemnity of the owner and the insurance needed for that indemnity – getting the contractor's "house in order"**

In most construction contracts between an owner and a contractor, or a contractor and a subcontractor, the party "downstream" in the chain of work will indemnify the party "upstream." Generally, this indemnity includes bodily injury and property damage arising from either the downstream party's work, or the negligence of the downstream party and its employees. There may be little negotiating room on these indemnity clauses. If the downstream party wants the

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<sup>7</sup> 136 A.D.3d 52, 22 N.Y.S.3d 24 (1<sup>st</sup> Dep't 2015).

<sup>8</sup> *Id.* at 60.

work, it typically agrees to the contractual terms and conditions as presented. The courts will generally enforce these clauses if they are consistent with governing law and statutes.

## **1. Recognizing the Contractual Indemnity and Managing its related risks**

The contractor must first understand that it has agreed to pay damages to or on behalf of the owner (or upstream contractor) if certain events occur. Once that understanding exists, the focus shifts to what trigger obligates the contractor to pay damages to or on behalf of the owner (or upstream contractor). Is it limited to bodily injury and property damage arising from the contractor's own work? Does it also include indemnity for the work of subcontractors? Answering these questions helps the contractor to determine if its insurance program provides adequate protection for these contractually assumed indemnities. Failing same, the contractor has left itself open to out-of-pocket costs when the upstream party (such as the owner) calls in its indemnity and no coverage exists. Few contractors have the resources or "deep pockets" to satisfy such an unfunded indemnity in a catastrophic injury case.

### **b. Transferring the Contractual Indemnity (and other Risk) to the contractor's downstream providers by contractual indemnity and insurance requirements**

Once the contractor recognizes the contractual indemnity it has assumed, and adequately insures it, the next step is to transfer that risk to downstream providers. For example, if a contractor agrees to indemnify an owner for loss or damage arising out of the contractor's work, this indemnity should also extend to the work performed by downstream subcontractors. To that end, the contractor should secure indemnity (by contract) from each of its downstream subcontractors, vendors, and suppliers ("downstream providers") for loss or damage arising out of their work and supplies. The specific indemnity terms and breadth vary by contract. However, the contractor should at minimum require the downstream providers to indemnify it to the same extent that the contractor agreed to indemnify the owner or upstream contractor (assuming that such indemnity agreement is lawful and enforceable).

Indemnity alone, however, does not adequately protect the contractor. In most instances, the issue of loss transfer downstream arises with downstream subcontractors. Many of these downstream subcontractors lack adequate capitalization, and ultimately may be unable to pay a judgment. Winning on a contractual indemnity claim, therefore, may be a hollow victory.

Therefore, the contractor's downstream subcontractor must not only contractually indemnify the contractor, but also under the contract must be required to purchase adequate insurance to fund that contractual indemnity. Typically the contract will also require that the downstream subcontractor purchase adequate CGL insurance, Workers Compensation & Employers Liability Insurance, Commercial Automobile Insurance, and Commercial Umbrella/Excess Liability Insurance. The policies as discussed above must name the contractor, and owner, as Additional Insureds.

In addition, a downstream subcontractor may be required to maintain additional types of insurance (*i.e.*, Professional Liability, Pollution Liability, etc.) depending on the scope of work being performed. Finally, depending on the terms of the contract, as discussed above, the downstream subcontractor may also be required to maintain Builders Risk/Installation Floater Insurance, which would protect the contractor's insurable interest in the applicable construction project.

Before the work begins, the contractor must confirm that the proper coverage has been purchased and is in effect, and that the contractor has been named as an Additional Insured on the downstream subcontractor's relevant policies.

In this way, if a bodily injury claim occurs on the project, and the owner tenders the claim to the contractor under the contractor's indemnity to the owner, (resulting in a notice of claim with the contractor's insurance carrier), the contractor can tender the bodily injury claim to its downstream subcontractor (and the subcontractor's carrier) for handling/disposition as an Additional Insured, and the contractual liability provisions in the subcontract.

Without such a loss transfer mechanism, the contractor may find itself between a rock and a hard place. It must contractually indemnify the owner, but cannot transfer this obligation to its downstream subcontractor or secure insurance coverage from the downstream subcontractor's CGL carrier. In such a case, "the buck stops here" for the contractor and its insurance carrier.

#### **Coverage Trap 4 – Not having enough liability insurance for the risk**

Contractors understand overhead, and balancing cost management with quality work. Some, however, view liability insurance as an overhead line item ripe for cutting. This view may be penny wise and pound foolish. Coverage limits maintained by a contractor should reflect the risks associated with the contemplated operations. Of particular concern are construction projects that involve work at elevated heights. The New York State Labor Law §240(1) holds owners, contractors and their agents statutorily liable for injuries to a worker resulting from a violation of the statute. For instance, if a 19 year old laborer is catastrophically injured on a construction site by falling from an "elevated height" (which could be as low as a step ladder), the contractor may face millions of dollars in damages. This risk – if not adequately covered – could jeopardize the business of many contractors.

#### **Coverage Trap 5 – Accepting a Certificate of Insurance as proof of being included as an Additional Insured on the policy**

In many construction contracts, contractors require their downstream subcontractors to include them as an Additional Insured on the subcontractor's liability insurance policies. This requirement may also apply between a subcontractor and a downstream sub-subcontractor. This process allows the contractor to claim against the downstream subcontractor's policy (rather than its own) if a subcontractor's work causes injury or damage. As a result, the subcontractor's policy would pay for defense costs and indemnity incurred by the contractor (thereby preserving the coverage of the general contractor's insurance policy). However, while conceptually simple, this process also requires attention to detail.

In most cases, a downstream subcontractor will provide the general contractor with a document, such as an "ACORD 25-3 (2014/01)", generally described as a "Certificate of Insurance." However, a Certificate of Insurance does not constitute or provide insurance coverage.<sup>9</sup>

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<sup>9</sup> *Three Boroughs, LLC v. Endurance Am. Specialty Ins. Co.*, 2016 NY Slip Op 06554, 2016 N.Y. App. Div. LEXIS 6442 (1<sup>st</sup> Dep't October 6, 2016) citing *American Ref-Fuel Co. of Hempstead v. Resource Recycling*, 248 A.D.2d 420, 423-424 (2d Dep't 1998).

Thus, a contractor should not accept an insurance certificate as proof of coverage, because it is not that. Instead, before the work starts, the contractor must receive actual proof of Additional Insured status that will be legally recognized and upheld. The downstream subcontractor should furnish to the contractor the declarations page from the downstream subcontractor's insurance policy (listing the named insureds and all policy forms/endorsements/exclusions) and the specific Additional Insured endorsement naming the contractor on the policy. We discuss this further below.

### **Coverage Trap 6 -- Not securing an "All Risk" Policy**

A well-rounded risk management program typically includes Builders Risk/Installation Floater insurance, which covers damage to the physical structure, and its related materials that may be in transit or stored offsite, during construction.

Problems arise when the contract does not establish who will secure the Builders Risk/Installation Floater coverage. To resolve this problem, many standard contract forms require that the owner purchase Builders Risk insurance. Even with contractually assigned responsibilities, however, often the owner may not be aware of the obligation or may assume that the contractor will cover it. A coverage trap can exist when none of the parties purchase this coverage, leaving a significant potentially uncovered loss for, among other things, the physical structure.

To address this potential coverage trap, the contractor should insist that it receive a copy of the builders risk policy that the owner purchased covering the project before starting work. The contractor should also review the policy to ensure that critical building components are covered (*i.e.*, the existing structure on a renovation job, property while in transit or at a temporary storage location, etc.) and to ensure the necessary endorsements are included on the policy (*i.e.*, Flood & Earthquake coverage, Equipment Breakdown, Soft Costs, Permission to Occupy).

## **PART II**

### **HOW TO AVOID THE CONTRACTOR INSURANCE TRAPS**

Contractors most often fall into insurance traps because they do not know where or how to look for them. In other cases, contractors do not have time to fully vet the contract or the insurance documents before starting a job. Still others lack the staff to do so. The good news is that contractors can significantly improve in this area, while still focusing on their core business, by setting up a vetting process for their contracts and business. This includes engaging an outside attorney and insurance professional.

#### **Getting started – you have expertise in your trade; expect the same of your advisors**

The construction industry lends itself to specialization. If a job involves electrical work, a professional electrician is hired. Alternatively, if a generator needs to be installed, an asphalt contractor probably would not be hired to perform the work.

Just like the construction trades, there are law firms and insurance agencies that specialize in construction risk management. When choosing these advisory partners, it is critical to first evaluate their construction-specific expertise.

Starting with the role of an attorney, the focus should be on contracts. A qualified attorney will draft construction contracts that adequately transfer risk through enforceable indemnification clauses, ensuring that the responsible party's insurance policy covers a claim. Contractors may find themselves in an "upstream" or "downstream" position within the construction hierarchy. When a contractor is working for an "upstream" party, *i.e.*, a general contractor ("GC") or owner, an attorney will help the contractor avoid signing contracts that contain onerous indemnification clauses, poor payment provisions, or non-applicable insurance requirements. Alternatively, an attorney will ensure that contracts with "downstream" parties (*i.e.*, subcontractors) properly transfer risk down to those parties. An attorney will also work hand-in-hand with an insurance agent to incorporate sound insurance requirements into the contract.

In the event of a claim (such as a construction defect or worksite injury), attorneys actively manage the claim. This entails defending the contractor, interpreting and enforcing contractual obligations, communicating with the plaintiff, and analyzing the coverage afforded by the applicable insurance policy for the benefit of the contractor.

As a complement to the work of an attorney, a qualified insurance agent will utilize its industry expertise and knowledge to customize a comprehensive insurance program that not only emphasizes coverage, but also employs pre-emptive risk control measures. All facets of a contractor's operation should be evaluated by the agent, creating an "enterprise-wide" approach to risk management. Insurance is certainly an important component of the risk management process, but equally critical is written contractual risk transfer, loss prevention (*i.e.*, OSHA and safety training), and loss mitigation (*i.e.*, record keeping and documentation). By thoroughly understanding a contractor's scope of operations, and addressing a contractor's exposures to loss before a claim happens, an insurance agent preserves the contractor's assets and company loss history while also presenting the contractor as best-in-class to potential insurance carriers.

Identifying and addressing a contractor's exposures to loss before a claim preserves the contractor's assets and company loss history, while also presenting the contractor as best-in-class to potential insurance carriers.

The combination of a competent attorney and qualified insurance agent assists the contractor with the purchase and design of its insurance program and the establishment of a sound contractual risk transfer program. The focus should be placed on preventing claims before they happen and/or mitigating the impact if they do happen (with insurance as a back-stop).

### **You have your resources in place – now what?**

Construction contracts heavily emphasize securing appropriate insurance protection for all parties involved, from the project owner down to the contractor and its subcontractors. The upfront concern for a contractor, therefore, should be to verify that its current insurance program meets the requirements in the construction contract. It is critical that the contractor, in conjunction with its attorney and insurance agent, review these insurance requirements as part of the overall bid process (as coverage changes may be needed, often at an additional cost). If these changes are not identified until after the bid is submitted, the contractor's already thin margins will further erode.

Most subcontractors working for an upstream contractor are on the receiving end of contractual indemnification and insurance requirements. As such, it is critical that these downstream subcontractors establish clear expectations for their work and fully understand the obligations imbedded within their indemnification clause running in favor of the upstream owner or contractor. The downstream subcontractor's insurance agent can then adjust its insurance program accordingly (if needed) and factor any cost into that subcontractor's project costs.

### **Confusion over “Additional Insureds”**

As discussed above, the term “Additional Insured” is a common but frequently misunderstood term for contractors. Under most construction contracts, an upstream contractor requires its subcontractors to provide it with Additional Insured status (effectively allowing the upstream contractor to tap into the downstream contractor's policies). Similarly, a downstream contractor will be required to name the owner and/or general contractor as an Additional Insured on its policies (effectively sharing its limits with the owner and/or upstream contractor). The market power of the respective players often determines their final obligations on this.

When it comes to construction contracts, insurance is simply the funding mechanism for an enforceable indemnification agreement. Additional Insured status helps to ensure that when indemnification is sought, the responsible party's insurance policy takes precedence (thereby preserving the policy limits of the Additional Insured). While a contractor cannot transfer its own negligence, it can protect against its vicarious liability that arises out of the acts of a third party (i.e. a subcontractor) via the Additional Insured function.

This mechanism is especially critical in New York State, where project owners can be held strictly liable for “gravity related” workplace injuries upon a violation of Section 240(1) of the New York Labor Law, (the “Scaffold Law”). Through a transfer of risk by owners, this law ultimately holds contractors absolutely liable (i.e. without consideration for fault) when workplace injuries stem from elevated work surfaces or falling objects violating the statute. This absolute liability takes away a contractor's ability to defend its actions (or point to its safety record) in these cases. Being entirely free of negligence and/or exercising due care is not a defense for the contractor. Furthermore, the contractor's liability isn't reduced by the injured employee's comparative negligence. Through proper Additional Insured status, however, the contractor can seek payment under that policy for its contractual indemnity claim against its downstream providers and subcontractors for its liability to an injured subcontractor.

Additional named insured status also brings up the concept of “primary non-contributing” insurance. In most general terms contribution in this context refers not to allocation of fault between the general contractor, owner, and sub-contractor in an underlying lawsuit, but the right of their insurers to claim contribution from each other depending on whether any of those insurers has paid more than their equitable share on a particular claim.

Thus, primary non-contributory coverage relates to the priority or order of coverage, not allocation of underlying fault. “Primary” means that one carrier will be the first carrier on the loss, and pay up to its policy limits. “Non-contributory” means that the second and third carriers in line will not pay anything to the first carrier for such costs, and will only provide coverage after the first carrier has exhausted its limits.



The language of the insurance endorsements and underlying contracts will determine whether a primary non-contributing scenario exists as to a particular claim.

### **Contracts are only a starting point**

While contractual obligations provide a baseline for required insurance, they are by no means an “end-all-be-all” for appropriate coverages and limits. Separate from contractual obligations, a contractor also has obligations to itself, its employees, and its shareholders.

Contracts alone, therefore, should not define the depth and breadth of insurance coverages and limits maintained by a construction firm. Rather, a comprehensive assessment of the work being performed by the contractor and the exposures present in that work should be conducted (while reviewing the obligations of the contract). One key item to note: do not confuse the dollar amount of the contract with the risk that a particular project presents. Switching out a light bulb might be a small job, but it also presents a Scaffold Law style exposure that could lead to a significant claim. It is imperative, therefore, as noted above, that the level of insurance equals the level of risk.

### **Partnership is a two-way street**

In a perfect world, a construction firm would have the necessary resources to hire an in-house risk manager to administer its insurance program and analyze its contracts (with a legal advisor and insurance professional). In reality, this work function often gets outsourced, so it is especially critical to partner with attorneys and insurance agents that have construction specific expertise and a broad understanding of contractual risk transfer. While insurance wording and contracts can appear overwhelming, a pro-active approach to loss control coupled with the right insurance and legal partners eliminates a lot of the uncertainty. Given the magnitude of risk inherent to construction, these measures are an essential component to a contractor’s future viability.