

Subcontractor General Liability Insurance Concerns

By: John H. Podesta

In this rapidly evolving market, many retail agents are experiencing problems in placing liability insurance for subcontractors. The following article is designed to highlight some of the limitations in subcontractors' liability policies that can create coverage gaps for the policyholder, and Errors and Omissions exposures for the agents.

Many of the newer insurers in the subcontractor market (as well as many established ones) are offering products that deal with specific underwriting concerns. Most products are manuscripted, meaning they are drafted by that insurance company. Therefore, when comparing quotes from multiple insurers, the protection afforded by each insurer can be markedly different. It is possible now to buy very restricted coverage for substantially less premiums than more standard coverage. There is often a very good reason the coverage is less expensive. The risk manager and the insurance broker need to stay on their toes, to understand the underwriting intent behind some of the key limitations and how it will impact the coverage they are buying.

MARKET OVERVIEW AND INITIAL QUESTIONS

From our view as coverage counsel, we typically see claims presented after projects are completed. Accordingly, our perspective as to what underwriters are trying to accomplish is a few years old. The policies being issued now have different limitations than the specific ones discussed herein. Nevertheless, we will try to make some general characterizations with regard to the market for subcontractor insurance.

First, the market reacts to court decisions, however, it is usually one to two years later. Some of the more common policy provisions we are seeing now are the direct result of court decisions that were rendered earlier this decade. Therefore, it is important for contractors and brokers to have some vehicle to get periodic updates on significant changes in the law. A significant decision today will likely result in different endorsements and limitations offered next year.

Second, many of the latest "innovations" in subcontractors' insurance are the carriers' response to additional insured claims being made by developers and general contractors in completed-operations construction defect claims. In a construction defect claim, the developer or general contractor tenders its defense to the insurers for the subcontractors, each of whom named the developer or general contractor as an additional insured. The developer or general contractor's defense is therefore shared between the "additional insured" carriers and their own "direct" carriers. Usually, the "additional insured" carriers pay between 65% and 100% of the developer or general contractor's defense for the action.

Subcontractor carriers are experiencing an enormous increase in defense costs expended for additional insured claims. Moreover, individual additional insurers have little or no control over how the developer or general contractors' defense is handled, including the costs incurred or experts retained. Insurance underwriters feel like cattle being prepared for slaughter. If they agree to provide additional insured coverage, there will certainly be a significant defense cost

exposure paid under that policy with little or no way to prevent it. As a result, underwriters have become more sophisticated in trying to limit exposure to such claims. Not surprisingly, when the insurer later denies coverage, the subcontractors or their customers may end up holding the bag.

First and foremost, the risk manager and the broker must understand the contractor's completed operations exposures.

For example, residential construction defect litigation tends to be a high frequency, low severity claim. Leaving aside the offensiveness of spending \$50,000-60,000 to defend an additional insured, when the Named Insured's exposure is less than \$10,000, the reality is that the indemnity payments for most subcontractors in residential construction defect litigation is fairly limited. This general rule may not apply to the larger subs dealing with the exterior issues, including stucco, EIFS, siding, roofers, framers and the like.

On the other hand, commercial exposures tend to be high severity, but lower frequency. An HVAC system on a commercial structure can be a \$20.0 million subcontract. If allegations of defective construction include claims relating to bacterial infection, it will be expensive to defend and settle that lawsuit. A curtain wall or glazing contractor on an office building may have a large potential exposure if the windows leak. Whereas residential construction defect claims can involve virtually every trade involved on a project, a commercial construction defect lawsuit normally involves no more than three or four constituent defect claims.

Within these general parameters of commercial versus residential, there are obviously subparts. For example, you will encounter insurers willing to underwrite contractors working on single-family houses, but not condominiums. Therefore, the first priority for an agent for subcontractors, or a Risk Manager, is to make sure that the carrier in question underwrites contractors that are consistent with the insured's business model. While this sounds simple, it is more complex than it seems:

- 1) If the insured does not construct condominiums, are they involved in constructing apartments that may be converted into condominiums at a later time?
- 2) If the insured does not construct condominiums, *per se*, do they construct duplexes, triplexes or town homes?
- 3) If the insured works principally on smaller developments, would they accept work on a large development if the contract presented itself?
- 4) Does the insured work on Commercial and Residential projects, or mixed use projects (ie, Retail development with condominiums on top.)
- 5) Is the insured involved in any high rise residential development (which could have a high frequency type claim from the homeowners, and high severity type claim because of the nature of high rise construction)?

The broker representing the subcontractor must understand the carrier's appetite for different types of structures, the work of the subcontractor *now*, and what projects the subcontractor *may take on after the policy incepts*.

The first line of defense for the carrier is to limit exposure to certain kinds of risks and insureds. The carrier does this by different types of "Designated Work" limitations. Depending on how well the limitation is written, the subcontractor might find itself with no coverage for projects beginning mid-term. Also, if the subcontractor may become involved in work that the carrier did not want to underwrite, far more claims and disputes will arise. Our suggestion would be to ask the following questions:

- 1) Is the carrier willing to underwrite the type of business that the subcontractor has been involved in, or may become involved in during the next year? If the answer is no, and that there are only certain categories that the underwriter is willing to underwrite, clear communications will be required of the insured to make sure that it understands the boundaries of its insurance coverage. Obviously, the actual policy language is vitally important.
- 2) Does the contractor have a consistent track record of the size and type of construction it engages in? If the answer is no, then the agent should make sure to advise the insured that some but not all of future projects may be insured by the policy (i.e., commercial but not residential; apartments but not condominiums; don't forget mixed-use!).

LIMITS ON COMPLETED OPERATIONS COVERAGE

The principal way for a carrier to limit its exposure to construction defect claims and their attendant additional insured claims, aside from choosing the risk wisely, is by limiting the Completed Operations coverage. By way of background, Completed Operations coverage is intended to cover the insured for damage that occurs during the policy period, arising out of past projects. In the ISO Form¹ that is prevalent in the industry, so long as there is covered damage that occurs during the policy period, the insured is covered. It is irrelevant whether the original construction was one year prior to the policy, or thirty years prior to the policy. So long as the insured does not know about the claim at the time the policy incepts, it would provide coverage.

In response to this open-ended assumption of liability past acts, there have been a number of responses to limit Completed Operations coverage, including:

- 1) Modifying the definition of "occurrence" to require that not only the damage, but the original work occur during the policy period (a "modified occurrence" policy);

¹ Insurance Services Office, or ISO. These are the standard forms used by most US insurers.

- 2) Including a Claims Made aspect to the policy that requires that a claim be made for otherwise covered damage within a set period of time after the policy expiration (a “sunset clause”). This would require that damage occur during the policy period, and that a claim for such property damage occur within that period of time following the policy expiration;
- 3) A limitation on continuous and progressive damages, such that if damage relating to the insured’s work commences prior to the policy period and continues into the policy period, there is no coverage (even if damage is not known to the insured at the time the policy is applied for);
- 4) A limitation that if the loss is known to the insured prior to the policy period then there is no coverage under the policy;
- 5) Prior Work exclusions that eliminate any Completed Operations coverage if the work that is the subject of the claim was performed prior to the policy period.

Each of these coverage limitations requires a modification of the Standard ISO Policy Form. Each carries its own chance of creating coverage gaps for the insured, when considering an insurance program over a several year period.

LIMITATIONS ON CONTRIBUTING WITH OTHER INSURERS

In addition to limitations relating to Completed Operations coverage generally, some carriers have specifically sought to limit their exposure only to other insurers. Fundamentally, under California law, the “Continuous Injury” trigger of coverage applies. Thus, any insurer covering the insured from the time that the damage first occurs are all liable to defend and indemnify the insured for otherwise covered damages. (Montrose Chemical Corp. v. Admiral Insurance Co. (1995) 10 Cal.4th 645; Stonewall Insurance Co. v. City of Palos Verdes Estates (1996) 46 Cal.App.4th 1810.)

Significantly, under an Additional Insured Endorsement, the California Court of Appeals held in 2000 that a single additional insured carrier had an obligation to defend the developer against all claims (Presley Company v. American States (2000) 90 Cal.App.4th 571.) Recently, however, there was a slight victory for the subcontractor insurers, when the Court of Appeals found that for claims that are not even potentially covered by the subcontractor’s policy, they are entitled to recoup some portion of the defense costs from the developer’s direct carriers. (Transcontinental v. Insurance Company of the State of Pennsylvania (2007) 148 Cal.App.4th 1296.) To avoid the scenario where the carriers are simply lumped together for joint and several liability, some subcontractor insurers have sought to position themselves vis-à-vis other insurers in a number of ways:

- 1) Excess Other Insurance clauses. Some insurers state that while they provide Additional Insured coverage, their obligation to actually pay defense costs are

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excess over all other Additional Insured coverage and direct coverage available to the developer or general contractor;

- 2) No defense obligation owing to additional insureds. Although there are no court decisions directed to this limitation, some carriers have sought to provide only Indemnity coverage for additional insureds, but no separate defense obligation

A particular concern of subcontractors must be Owner Controlled Insurance Programs, or OCIPs. Most subcontractors participate in OCIP's for at least some of their projects. The subcontractor is to delete their insurance cost for that project and allow the Owner's coverage to protect the subcontractor. Since the premium associated with that project is deleted from the regular insurance program², the carrier will want to exclude coverage for the project.

The contractor or broker must understand the nature of the OCIP risk, and consciously approach that risk with the non-OCIP insurance program. Many carriers are now excluding any of the insured's liability at a project insured under an OCIP, *even if the contractor does not enroll or decides not to be a part of the OCIP*. Other endorsements make the non-OCIP policy excess coverage to the OCIP.

LIABILITY TO SUBCONTRACTOR AND BROKER FOR IMPROPER INSURANCE

The subcontractor may find itself with a gap in coverage. This could occur if, for example, all of the policies in effect between the time of construction and the time of the Complaint being filed contain Prior Work exclusions. Under those exclusions, if the work that is the subject of the lawsuit was done prior to the policy period there is no coverage. Conceptually, so long as work causes some damage before the policy expires, then it would apply even if subsequent policies also exclude "prior work". If, however, the insured's work is defective but it does not cause damages until after the expiration of the first policy, none of the policies would cover that loss. As an example, in United National v. Frontier Insurance (2004) 120 Nev. 678, the insured installed a sign that blew over two years after its installation in a heavy wind storm. If there is no damage until the wind storm occurs, but the policy in effect at that time had a "Prior Work" exclusion, the subcontractor would have no coverage.

Other gaps in coverage could occur where there are "modified occurrence" type forms and "Sunset" clauses. For example, some policies require that a loss become "known to somebody" during the policy term. While seemingly innocuous on its face, that limitation requires that the construction be performed prior to the policy period, and that somebody become aware of the defective condition and damages during the policy period; as time progresses, it is more and

² Typically, the premiums of a contractor are a percentage of the amount of "receipts" or more typically "payroll" for the year. If the payroll for an OCIP is deducted from the other payroll, the premium will not include that derived from work on the OCIP project.

more difficult to prove that there is “actual knowledge” during that policy period and the insured may effectively (though not actually) have a gap in their collectible insurance program.

The gap in coverage also means that the subcontractor may be in breach of contract with the developer or general contractor if there is more limited Additional Insured coverage than required by the subcontract or agreement. If the broker issued a certificate to the general contractor, there is a potential exposure to the broker for misrepresentation. Normally, claims against the broker are not pursued since they require the developer to prove it has suffered an uninsured loss as a result of the lack of insurance by the particular subcontractor. In most construction defect litigation, where there are myriad of insurance policies available, this is a very difficult burden.

CONFIRMING PROPER COVERAGE

First, with regard to the main policy form, the broker should look to see if it is written on an ISO Form. If there is no copyright notice, or if it says that “portions” are copywritten, then the company has modified the industry standard form and more care should be taken.

- **The Insuring Agreement:**

With regard to the form itself, we suggest the first place to look is the Insuring Agreement. Since 2001, the Standard ISO Form has precluded coverage if the named insured (or authorized employee) knew of the loss or damage prior to the policy’s inception. A “Known Loss” limitation is to be expected. However, we are seeing a number of carriers modify the Insuring Agreement dramatically in their own forms, rather than by an endorsement that would call it to the attention of the insured and broker that there is a modification. Among the changes to the Insuring Agreement we have seen include:

- 1) The insertion of the limitation that the damage must be “known” during the policy period;
- 2) An insertion that the duty to defend extends to some but not all “insureds” under the policy; and
- 3) An insertion that a claim resulting from any “occurrence” must occur within a period of time after the policy expires.

- **Contractual Liability Coverage**

An extremely important coverage to subcontractors is Contractual Liability coverage. In a rather convoluted fashion, such coverage provides that where the insured assumes the liability of another (general contractor or developer) in a contract or agreement, the assumed liability is covered under the subcontractor’s insurance. The typical ISO policy excludes such coverage, and then states the exclusion does not apply if the contract is an “insured contract.” A review of

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the insured contract definition is critical to confirm that one of the types of “insured contract” includes “any other contract or agreement under which you assume the tort liability of another...” Some carriers try to limit their exposure to contractual liability claims by eliminating this “catch all” type of contract. Therefore, even though the exclusion states that it provides coverage assumed under an “insured contract,” the policy does not provide the coverage expected by the insured and broker.

- **Non-Standard Additional Exclusions**

Some carriers are also building other provisions into the exclusions. The Standard ISO Form contains exclusions A through O relating to bodily injury and property damage coverage. We are aware of one carrier’s form that actually extends from exclusions A through Z, and then through DD. If the policy contains more than exclusions A through O, they should be read carefully.

- **Is Defense Within Limits, Or In Addition To Limits?**

The typical general liability policy states that the company’s limit of liability is stated in the declarations (Say, \$1.0 million); the broker should check the Limit of Liability and the Supplementary Payments portions of the policy to make sure that policy is consistent with your expectations. If the defense is supposed to be in addition to the limits, Supplementary Payments should state, at the conclusion, that payments made under this Section do not reduce the limit of insurance. The Limit of Liability Section should state that it relates to damages under Coverages A and B. If Limits of Liability contain a paragraph that states that Supplementary Payments are included in the Limit Liability, the policy is “defense within limits.”

- **Review the Other Insurance Clause**

Finally, a quick review of the “Other Insurance” clause ought to be undertaken if the form is manuscripted. If there are provisions that purport to make the policy specifically excess over other coverage, including coverage available to additional insureds, it may place the subcontractor in breach of the contract with the developer or general contractor.

- **Review the Endorsements For Further Limitations**

For most carriers, at least those that don’t use their own form, the endorsements attached to the policy are the most important part of the policy. The endorsements tell the broker and the risk manager what the real concerns of the underwriter are, and what risks they are trying to avoid. By looking at the endorsements, the experienced broker can determine whether the carrier is right for the client. The broker should bear in mind that the endorsement will take precedence over the main policy form as a matter of contract interpretation. (A more specific policy term

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will take precedence over a more general policy term.) Therefore, if the endorsement specifically addresses the claim situation, and it conflicts with the more general coverage, the endorsement prevails. We suggest that particular attention be paid to the forms used by the carriers with regard to the following:

- 1) Continuous and Progressive Damage Limitations;
- 2) Known Loss Limitations (known by whom, it is important if it refers to any insured or the named insured);
- 3) Terms of Blanket Additional Insured Endorsements (does the policy form limit coverage under Additional Insured Endorsements to “Ongoing Operations,” or does it include “Completed Operations” of the named insured. Also, does the blanket additional insured have any limitation with regard to the type of contract that will be considered (i.e., written contract, fully executed contract, contract entered into prior to the inception of the policy, etc.);
- 4) Designated Work Limitation, including Condominium Exclusions. A Designated Work Limitation could render the coverage grant a mockery. For example, if the “designated work” includes residential construction, prior work or some other description which could relate to something the subcontractor is involved in, be careful. In addition, a trap for the broker exists if it issues a certificate of insurance or additional insured endorsement, when there is a designated work limitation that could eliminate any coverage for the project under construction, but that is not disclosed on the certificate.

AGENTS REPRESENTATIONS MAY BE BINDING

As an insurance broker, representations made can be actionable. An insurance agent bears potential liability not only for failing to obtain coverage needed by the client, but may be held liable for statements made directly to third persons. By way of example, the Court of Appeals in Eddy v. Sharp (1989) 199 Cal.App.3d 858, found that an insurance agent was liable to a policyholder under a property policy. The agent had provided a description of the coverages, but failed to include that the policy excluded damage caused by flood. When the flood occurred, the Court found that the agent’s statement that they would provide coverage subject to the terms of the quotation were binding.

In the context of subcontractors, the principle exposure is the issuance of Certificates and Additional Insured Endorsements. Certificates with regard to each account should contain information which would bear directly on the developer or general contractor’s reasonable expectation of coverage under the policy, when and if a construction defect or construction operations claim is presented. Many general contractors now have Contractor Warranty Endorsements which require the developer to obtain minimum coverage from each one of its subcontractors, or risk having no coverage under their direct program. While the stakes may be

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higher, clear representations regarding obvious limitations in the policy should be made on the Certificate or in an attachment for so there is no claim that the agent misrepresented what coverage was actually available.

With regard to representations, attention should be paid to the following:

- 1) If there is any variation between the policy and the subcontract insurance requirements signed by the insured;
- 2) If there is any Modified Occurrence or Sunset clause;
- 3) If there is no coverage for the additional insured for Completed Operations (i.e. the Additional Insured Endorsement applies only to “ongoing operations”);
- 4) If there is a Deductible or Self-Insured Retention that must be satisfied by the named insured before there is any coverage owing to the named or additional insured;
- 5) If there is any Designated Work Limitation that could arguably apply;
- 6) If there is any limitation on the defense that that would be payable to the additional insured (i.e., no defense or excess Other Insurance clause) should be disclosed.

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