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Not the Usual Suspects: The Other Contract Provisions that Impede Risk Transfer

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Session Title: Not the Usual Suspects: The Other Contract Provisions that Impede Risk Transfer

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Brian Rice is Vice President, Associate General Counsel and Chief Litigation Counsel for RailWorks Corporation. Brian has primary responsibility within the legal department for RailWorks' form contracts, risk management, and insurance and is actively involved in RailWorks' contract negotiations across its business units. Brian is also responsible for overseeing all claims, excluding workers' compensation, and litigation for all of RailWorks' subsidiaries.

Overview

Contract provisions are an important tool in clarifying risk allocation, specifying or limiting remedies and damages, and triggering insurance coverage. Construction lawyers, insurance brokers, and coverage lawyers can usually rely on strong indemnity agreements and insurance provisions to make sure they are effectively transferring risk downstream and toward insurance policies that were purchased to accept the risk. But what happens when those other provisions in the contract get in the way? A strong contract provision may be effective in avoiding liability, but it can create a costly dispute about insurance coverage. This session will explore the other common provisions found in construction contracts that can impede effective risk transfer, an exploration of carrier responses, and real-life case examples to shape a discussion around best practices.

Financing Risk

Parties to construction contracts manage risk in two ways: buying insurance and apportioning between them. When parties focus only the latter, they can unknowingly take insurers out of the equation or at least make it difficult to access the insurance. This is not only economically inefficient but also has the potential to encourage protracted disputes about fault, liability, and proximate cause that cost time and money. The goal of a good contract should include triggering coverage before apportioning loss.

A. Accessing First-Party Coverage

Contracting parties agree to purchase first-party insurance coverage to cover losses that are not caused by the acts of either party, and to avoid costly disputes about liability for certain types of losses that may be caused by liability. Liability coverage only covers damages the insured becomes legally obligated to pay, so triggering coverage requires a determination of a party's liability. Parties are incentivized to avoid liability, and liability policies encourage this by providing a defense. As a result, and as discussed in more detail below, accessing liability coverage necessarily requires parties to make claims against one another, triggering defense costs and uncertainty about which policy has an obligation to pay the loss. To avoid these costs and uncertainty, parties who have agreed to finance risk by way of a first-party insurance product should endeavor to access the first-party insurance to reduce disputes, costs, and uncertainty.

Damage to property to be incorporated into a construction project is covered by a builder's policy, and parties should encourage the presentment of losses for payment under the builder's risk policy before encouraging parties to make claims against one another. The best way to do this is to include a waiver of claim provision whereby the parties waive all claims against each other to the extent the losses are covered by the builder's risk or other first-party insurance coverage for the project. Such a provision prevents an upstream party from having a choice between pursuing first-party coverage and bringing a claim against the downstream party for losses that they may have caused.

B. Accessing Liability Coverage

When losses are not covered by first-party coverage and were caused by the acts or omissions of another party, third-party coverage comes into play. Triggering third-party

coverage generally requires a claim, or allegation of liability, to be made against the insured.[1] Standard policies are written with a prejudice toward a typical claim sequence:

1. Injury occurs
2. Injured party (plaintiff) sues the potentially liable party (defendant)
3. Defendant tenders suit to its liability carrier for defense and indemnity
4. Liability carrier engages defense attorney
5. A judgment determines the insured's liability

At any point during the above process, a settlement may occur based on the likelihood of a liability outcome.

In the construction context, the existence of a "claim" against the insured is not always as clear as in other areas of the law. For example, consider a situation where a Contractor causes damage to other property on the jobsite belonging to the Owner. It is axiomatic that the Contractor is liable to the Owner for the damage that it caused pursuant to a negligence theory. The Contractor owed the Owner a duty of care to protect its property; it breached that duty and therefore, owes the Owner damages. The Owner could bring a negligence lawsuit against the Contractor to recover those damages, and a general liability carrier would defend and indemnify the Contractor against those claims, to the extent of the coverage.

But what happens when the Owner takes advantage of other remedies available under the contract to recover its damages? Construction contracts often allow Owner to order corrections, repair corrections themselves, and withhold or offset payments to Contractors. These contract remedies are often premised on the Contractor's liability for negligently causing damage. Unfortunately, liability insurers are not always quick to recognize the negligence claim that is hiding beneath the surface. As a result, the contract provisions that are intended to keep the project moving and protect the parties can sometimes have the unintended effect of fooling an insurer into thinking they no longer have an obligation to cover the negligence "claim."

1. Definition of Suit

In a liability policy, the term "suit" is limited to civil proceedings, including arbitrations and other alternative dispute resolution proceedings to which the insurer consents.[2] When an Owner sends a demand letter to a Contractor, that is not a "suit." The insurer's duty to

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[1] *We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. … We may at our discretion, investigate any "occurrence" and settle any claim or "suit" that may result. …*
(CG 00 01 04 13; Section I – Coverages, A.1.a.)

[2] *"Suit" means a civil proceeding in which damages because of "bodily injury", "property" damage" or "personal and advertising injury" to which this insurance applies are alleged. "Suit" includes:*

(a) An arbitration proceeding in which such damages are claimed and to which the insured must submit or does submit with our consent; or

(b) Any other alternative dispute resolution proceeding in which such damages are claimed and to which the insured submits with our consent.

(CG 00 01 04 13, Section V – Definitions, para.18.)

defend has not been triggered, but that does not mean the insurer does not have any obligation to do anything. The insurer must still investigate the claim, and the insurer must still pay the damages for which its insured is liable, to the extent covered by the policy. The absence of a "suit" does not eliminate coverage – it just means the duty to defend has not yet been triggered.

A claim will often start when the Owner sends a letter to the Contractor identifying damage and demanding the Contractor repair or remedy the damage in accordance with some contractual obligation to do so. The Owner might reference a provision, like Section 10.2.5 of the AIA A201, which requires the Contractor to promptly remedy damage and loss caused by the Contractor.[3] If the Contractor disputes that it was the cause of the loss, this provision shifts the burden to the Contractor to make a claim against the Owner to recoup the costs of remedying the damage. The AIA provision contains an exception for losses covered by first-party property insurance, avoiding potential burden shifts. But when first-party property insurance does not apply, it's important to consider how the liability coverage will be triggered.

There are other common self-help provisions that allow an Owner to take measures to protect itself from losses short of bringing a suit, or even a claim, against the Contractor. These include Change Directives and rights to withhold.

2. Withholding Provisions

Both the Consensus Docs[4] and AIA Documents[5] contain provision allowing Owners to withhold funds from payment requisitions to offset losses caused by the Contractor.

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[3] ***§ 10.2.5*** *The Contractor shall promptly remedy damage and loss (other than damage or loss insured under property insurance required by the Contract Documents) to property referred to in Section 10.2.1.2 and 10.2.1.3 caused in whole or in part by the Contractor, a Subcontractor, a Sub-subcontractor, or anyone directly or indirectly employed by any of them, or by anyone for whose acts they may be liable and for which the Contractor is responsible under Sections 10.2.1.2 and 10.2.1.3. The Contractor may make a Claim for the cost to remedy the damage or loss to the extent such damage or loss is attributable to acts or omissions of the Owner or Architect or anyone directly or indirectly employed by either of them, or by anyone for whose acts either of them may be liable, and not attributable to the fault or negligence of the Contractor. The foregoing obligations of the Contractor are in addition to the Contractor's obligations under Section 3.18.*

[4] *9.3 ADJUSTMENT OF CONSTRUCTOR'S PAYMENT APPLICATION Owner may adjust or reject a payment application or nullify a previously approved payment application, in whole or in part, as may reasonably be necessary to protect Owner from loss or damage based upon the following, to the extent that Constructor is responsible under this Agreement:*

…9.3.2 Except as accepted by the insurer providing Builder's Risk or other property insurance covering the project, loss or damage arising out of or relating to this Agreement and caused by Constructor to Owner or to others to whom Owner may be liable;

… 9.3.7 uninsured third-party claims involving Constructor, or reasonable evidence demonstrating that third-party claims are likely to be filed unless and until Constructor furnishes Owner with adequate security in the form of a surety bond, letter of credit, or other collateral or commitment sufficient to discharge such claims if established.

[5]***§ 9.5 Decisions to Withhold Certification***

§ 9.5.1 *The Architect may withhold a Certificate for Payment in whole or in part, to the extent reasonably necessary to protect the Owner, if in the Architect's opinion the representations to the Owner required by Section 9.4.2 cannot be made. If the Architect is unable to certify payment in the amount of the Application, the Architect will notify the Contractor and Owner provided in Section 9.4.1. If the Contractor and Architect cannot agree on a revised amount, the Architect will promptly issue a Certificate for Payment for the amount*

1. Change Directives

The AIA contract forms include a provision allowing for the Owner to issue a "Change Directive" to alter the scope of the contract by adding work when the Owner and Contractor have not yet reached agreement on any adjustments to the Contract Sum or Contract Time.[6] In essence, the Owner has the authority to direct the Contractor to perform the work without having determined whether or how much it will pay the Contractor. This process can run afoul of insurance obligations when it is later alleged that the additional work was caused by the Contractor.

Take an example where damage occurs on a project, and the Contractor has no basis to believe it did anything wrong. The Owner issues a change directive requiring the Contractor to perform the work, the Contractor incurs costs to make the repairs and seeks reimbursement from the Owner. The Owner then turns around and claims that the damage was the Contractor's fault and denies the Contractor's claim for payment.

The Contractor has already borne the cost of repairing the damage, but it is just now learning that the Owner believes the damages were caused by the Contractor's negligence. The Contractor tenders the "claim" to its liability insurer. The liability insurer may take the position that there is no claim, that the liability is contractual, and that the Contractor voluntarily paid the claim by performing the repair work without the insurer's consent.

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for which the Architect is able to make such representations to the Owner. The Architect may also withhold a Certificate of Payment or, because of subsequently discovered evidence, may nullify the whole or a part of a Certificate of Payment previously issued, to such extent as may be necessary in the Architect's opinion to protect the Owner from loss for which the Contractor is responsible, including loss resulting from acts and omissions described in Section 3.3.2, because of

- **.1** *defective Work not remedied;*
- **.2** *third party claims filed or reasonable evidence indicating probable filing of such claims, unless security acceptable to the Owner is provided by the Contractor;*
- **.3** *failure of the Contractor to make payments properly to Subcontractors or suppliers for labor, materials, or equipment;*
- **.4** *reasonable evidence that the Work cannot be completed for the unpaid balance of the Contract Sum;*
- **.5** *damage to the Owner or a Separate Contractor;*
- **.6** *reasonable evidence that the Work cannot be completed within the Contract Time, and that the unpaid balance would not be adequate to cover actual or liquidated damages for the anticipated delay; or*
- **.7** *repeated failure to carry out the Work in accordance with the Contract Documents.*

§ 9.5.2 *When either party disputes the Architect's decision regarding a Certificate for Payment under Section 9.5.1, in whole or in part, that party may submit a Claim in accordance with Article 15.*

[6] ***§ 7.3 Construction Change Directives***

§ 7.3.1 *A Construction Change Directive is a written order prepared by the Architect and signed by the Owner and Architect, directing a change in the Work prior to agreement on adjustment, if any, in the Contract Sum or Contract Time, or both. The Owner may by Construction Change Directive, without invalidating the Contract, order changes in the Work within the general scope of the Contract consisting of additions, deletions, or other revisions, the Contract Sum and Contract Time being adjusted accordingly. …*

§7.3.6 *Upon receipt of a Construction Change Directive, the Contract shall promptly proceed with the change in the Work involved and advise the Architect of the Contractor's agreement or disagreement with the method, if any, provided in the Construction Change Directive for determining the proposed adjustment in the Contract Sum or Contract Sum.*

The situation can be compounded if the claim arose out of professional services. Claims-made professional liability policies require claims to be reported within the policy year. When an allegation, even a baseless one, is made months after the repair work was performed, it can become impossible to comply with the policy's notice provision. Because notice may now be untimely, and the professional liability insurer may insist that the liability claim is actually a rectification claim for which consent was not sought.

When the Owner takes advantage of these self-help provisions, the Owner no longer needs to bring a "claim" for damages against the Contractor because the Contractor has already repaired the damage at its own cost. Can the Contractor recover from its liability insurer for its costs to remedy? The answer should be "yes", because the cost of repairing the damage is functionally the same as damages for liability because of property damage for which the Contractor is legally liable. If the Owner repaired the damage itself or hired a third party to repair the damages, it could bring a negligence claim against the Contractor and recover those damages.

But when the Contractor repairs the damages pursuant to a contractual obligation to do so and then brings a payment claim against the Owner to recover its costs, the situation starts to look different to the liability insurer, even though it is functionally the same.
An insurer might say there is no claim against the contractor in this situation. Then why is the Owner asserting it does not have to pay the Contractor for the work? If it is because the Owner alleges that the Contractor caused the damage, then you have a claim that the Contractor is legally liable for damages because of property damage and the general liability policy is triggered.

An insurer may take the position that the claim is contractual and therefore excluded by the contractual liability exclusion.[7] Typical contractual liability exclusions only apply to damages by reason of assumption of liability in a contract or agreement. They do not apply to liability that would have existed in the absence of a contract. While the Contractor's obligation to repair the damage or perform directed work may be written into the contract, the Contractor's legal liability to pay damages because of property damage proximately

[7] Contractual liability exclusions eliminate coverage for liability that would not otherwise exist, but is assumed in a contract.

> *This insurance does not apply to … "bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:*
>
> *(1) That the insured would have in the absence of the contract or agreement; or*
>
> *(2) Assumed in a contract or agreement that is an "insured contract", provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement. Solely for the purposes of liability assumed in an "insured contract", reasonably attorneys' fees and necessary litigation expenses incurred by or for a party other than an insured are deemed to be damages because of "bodily injury" or "property damage", provided:*
>
> *(a) Liability to such party for, or for the cost of, that party's defense has also been assumed in the same "insured contract"; and*
>
> *(b) Such attorneys' fees and litigation expenses are for defense of that party against a civil or alternative dispute resolution proceeding in which damages to which this insurance applies are alleged.*
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> *(CG 00 01 04 13, Section I – Coverages, A.2.b.)*

caused by its negligent acts is common law tort liability. And tort liability does not become contractual liability just because it is written in a contract.

An insurer might claim that the Contractor is seeking to recover its first-party losses from a third-party liability policy. Again, this is not necessarily the case when an Owner alleged the Contractor was liable for the damages. Contractors can curb these types of arguments by tendering to the carrier and seeking consent before incurring the costs.

Finally, an insurer might claim that when the Contractor incurred the cost to repair the damage, the Contractor made a voluntary payment to the Owner to "settle" the claim.[8] Again, the best way to avoid this is to tender the carrier and seek consent before incurring costs.

To be sure, we are not advocating for the elimination of useful self-help provisions discussed above. Rather, Contractors and Owners need to be aware of them and how their rights and obligations under the Contract can shape behavior in a way that may not neatly align with the terms of typical insurance policies. The goal is to avoid walking into a situation where the "claim" is hiding. Good claims practices and good communication between risk management and project teams are essential to ensuring that "claims" look like "claims."

2. Consequential Damages Waivers

Consensus Docs[9] and AIA[10] contain Consequential Damages Waivers, as these provisions have become increasingly ubiquitous. The goal of these provisions is to reduce the overall

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[8] Standard commercial general liability policies contain provisions prohibiting the insured from making voluntary payments. The standard ISO language also prohibits the insured from assuming any liability, or incurring any expense without the insurer's consent.

> *No insured will, except at the insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.*

(CG 00 01 04 13, Section IV – Commercial General Liability Conditions, 2.d.)

[9] *6.6 LIMITED MUTUAL WAIVER OF CONSEQUENTIAL DAMAGES Except for damages mutually agreed upon by the Parties as liquidated damages in § 6.5 and excluding losses covered and proceeds paid by insurance required by the Contract Documents, the Parties agree to waive all claims against each other for any consequential damages that may arise out of or relate to this Agreement, except for those specific items of damages excluded form this waiver as mutually agreed upon by the Parties and identified below. The Owner agrees to waiver damages, including but not limited to Owner's loss of use of the Project, any rental expenses*

[10] ***§ 15.1.7 Waiver of Claims for Consequential Damages*** *The Contractor and Owner waiver Claims against each other for consequential damages arising out of or relating to the Contract. This mutual waiver includes*

> **.1** *damages incurred by the Owner for rental expense, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and*
>
> **.2** *damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit, except anticipated profit arising directly from the Work.*

This mutual waiver is applicable, without limitation, to all consequential damages due to either party's termination in accordance with Article 14. Nothing contained in this Section 15.1.7 shall be deemed to preclude assessment of liquidated damages, when applicable, in accordance with the requirements of the Contract Documents.

pool of claims on both sides, reducing risk to those damages that are directly related to the contract. This allows parties to avoid excessive liability exposure to damages that may not be reasonably foreseeable. Whether this is a positive or negative largely depends upon what side of the claim you are on. What both parties should be able to agree upon, though, is that it is not economically efficient to pay for insurance that you cannot access. And that is exactly what can happen when a consequential damages waiver does not contain an exception for damages that are covered by insurance. This is one area where the Consensus Docs and AIA differ – the Consensus Docs provision includes such an exception.

3. Mandatory ADR Provisions

Parties to a construction dispute that has coverage implications should be aware of the facts that are necessary to determine the coverage dispute. The streamlined nature of ADR procedures, including limitations on document discovery, depositions, and reasoned decisions have the potential to frustrate coverage. When coverage turns on the factual findings of the underlying case, it is important that the parties utilize a process that will result in the necessary findings. Arbitration provisions, especially mandatory arbitration provisions, should take into consideration that certain facts may be necessary to determine whether insurance coverage is available to cover a damages award.

Conclusion

The complexity of construction contracting arrangements requires parties to agree on risk transfer, self-help measures, and other provisions to prevent disputes from delaying completion. These provisions can alter the typical posture of a liability claim, leading to difficulties in accessing coverage. Contracting parties should take care that the drafting and negotiation process occurs with a solid foundation of how insurance coverage is triggered to avoid exacerbating these issues. Moreover, risk managers and claims professionals should think about the fundamentals of a claim when identifying issues and presenting them to their insurers to highlight the fundamental claim that may be obfuscated by the posture of the contracting parties. Documenting claims and remedies in real-time in a way that aligns with the language of insuring agreements can help parties set their claims up for success.