



» Contractual Risk Transfer: The Fourth "C" Of Surety Bond Underwriting

Most everyone knows the three "C's" of surety bond underwriting: Capital, Capacity and Character. There is a fourth "C" that deserves to be considered by every construction surety underwriter: Contractual Risk Transfer (CRT).

Wedged somewhere between the ever-changing landscapes of construction law and insurance law, CRT has become one of the most important aspects of a contractor's business. Surety underwriters can learn a great deal about a contractor by examining the contractor's CRT practices, especially in terms of its effect on the contractor's Capital, Capacity and Character.

What Is Contractual Risk Transfer?

The primary purpose of CRT is to transfer the legal liability and responsibility for certain potential losses to another party. This transfer is accomplished through the use of various provisions within the construction contract. The processes that a contractor has in place to evaluate their contracts should address the following risk transfer mechanisms and their potential financial impact.

Indemnity Provisions

Indemnity provisions are the most common method of shifting risk contractually. Indemnity provisions, which are often referred to as hold harmless provisions, state that one party to the contract will pay and/or reimburse the other party for certain losses it incurs. The scope of the liabilities transferred by indemnity provisions can vary greatly and is statutorily regulated in many states.

Most contractors are able to obtain insurance coverage for the indemnity obligations they assume, but this coverage is usually limited to losses resulting in bodily injury and/or property damage sustained by a third party. Thus, if a contractor has signed an indemnity agreement that includes losses beyond third party bodily injury and property damage, that contractor has created an uninsured exposure for itself.

Additional Insured Requirements

Another common method of CRT is the additional insured requirement, by which one party to the contract (typically the lower-tiered party) is required to name the other party as an additional insured under the first party's insurance policy. This practice is most crucial for Commercial General Liability exposures.

In theory, the additional insured would be entitled to all of the same coverages provided to the named insured on the policy. In reality, most insurance policies limit the coverages available to additional insureds. Thus, if a contractor has not specified the coverages required in the contract or has not reviewed the terms of the additional insured coverage provided by the other party, it runs the risk that any future losses may not be covered.

Waivers of Subrogation

In order for indemnity provisions and additional insured requirements to transfer risks as intended, it is

imperative that contractors utilize waivers of subrogation as well. Generally speaking, insurance companies are permitted to recoup ("subrogate") the claims they have paid to the extent that the claim was caused by a party other than the insured. Waivers of Subrogation should be used in construction contracts in conjunction with indemnity provision and additional insured requirements because they state that one or both parties waives its rights (and consequently the rights of its insurer) of subrogation against the other. Without a Waiver of Subrogation, indemnity provisions and additional insured requirements are rendered ineffective.

Waivers of Consequential Damages

Consequential damages, such as lost revenues and lost profits, are those that are not a direct result of the responsible party's acts or omissions. Some construction contracts contain provisions whereby one or both parties give up their rights to recover consequential damages in the event of a loss, regardless of whether the at-fault party has insurance coverage for such damages. These waivers transfer the risk of consequential loss back on the injured party. Often, the amount of consequential damages far exceeds the amount of actual damages. For example, if a contractor accidentally hits an underground power cable while building an addition to an existing casino, the revenues lost by the casino as a result of being forced to close for an evening would far outweigh the cost to repair the damaged cable. Contractors that utilize waivers of consequential damages in their contracts drastically limit their potential liability.

Payment of Deductibles

Many project owners provide contractors with Builder's Risk insurance. Some contractors assume that because they are receiving coverage under another's policy, that they have successfully transferred the risk of property loss. Most contractors contractually agree to pay the Builder's Risk deductible if the contractor's property is damaged without inquiring as to the deductible amount, (which tends to be quite large). Contractors also usually agree to pay the deductible regardless of fault, meaning that the contractor will pay the deductible even if the property damage was caused by another contractor on the job with little chance of recovery.

How Does CRT Affect The Three "C's"?

Capital

The most obvious correlation between CRT and the three "C's" is the effect on a contractor's capital. The primary purpose of CRT is to keep the contractor from having to spend money. If a contractor can minimize its liability with CRT practices, that contractor will pay fewer claims. Many contractors also have loss sensitive insurance programs, meaning that the amount of their insurance premiums is dependent upon the number and severity of losses they incur. Even if a contractor has claims made against it, CRT practices can minimize the claims paid by its insurance carrier; potentially decreasing the contractor's insurance premiums while preserving their available limits of insurance. These savings can have a profound impact on the contractor's available capital and that contractor's ability to fulfill its performance and payment obligations, thus making the contractor a more attractive surety client.

Capacity

The effect that CRT has on a contractor's capacity is less obvious, but equally valid. A contractor's capacity is dependent upon its access to quality personnel and proper equipment. Sound CRT practices can minimize the strain placed on a contractor's personnel and equipment in the event of a claim. A broad transfer of risk will include losses to the contractor's equipment (usually to the extent caused by the lower-tiered party) in addition to losses suffered by third parties. A well drafted risk transfer provision will clearly allocate responsibility and will not require interpretation in the event of a loss. Not only will the claims be paid quickly, but the contractor will not lose access to key personnel forced to spend their time participating in investigations and litigation proceedings.

Character

Of the three "C's", character has always been the most difficult for surety underwriters to quantify and

measure. A contractor's level of commitment to sound CRT practices is a means to evaluate that contractor's character. There are many contractors that sign contracts without reading them. By doing so, these contractors are assuming a great deal of risk, not only for themselves but for their sureties as well. Those Contractors that are committed to reviewing their contracts, to understanding how the different risk transfer mechanisms operate and to negotiating aggressively for beneficial terms are demonstrating their dedication to the overall success of the company and to the relationship between the client and its surety.

In conclusion, surety underwriters must have an understanding of their clients' activities to properly evaluate the potential risks involved. It is crucial for surety underwriters to understand what contractors are agreeing to in their contracts and the processes used by these contractors to address CRT issues. While it might not ever become the official fourth "C" of surety bond underwriting, CRT can provide underwriters with a great deal of insight into a contractor's Capital, Capacity and Character.

This is the second in a series of articles on Risk Management and Insurance coordinated by the NASBP Risk Management and Insurance Committee. The author of this article is George Schneller, J.D., Contract Administrator, of IMA of Texas, Inc. in Dallas, Texas.

