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Confirming Coverage: The Importance of Vetting Downstream Insurance



The cost of insurance is often a critical factor driving subcontractor pricing. While alternative risk transfer schemes—such as consolidated insurance programs—have grown in popularity, the typical upstream/downstream structure where owners and general contractors contractually require downstream entities to procure insurance remains a common approach.

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Parties to upstream/downstream structured subcontracts often assume that carefully crafted insurance requirements on an executed contract are sufficient to ensure the designed risk transfer scheme executes properly. However, this overlooks a critical step: vetting the insurance program, which requires both parties collaborating to scrutinize the downstream insurance contracts to ensure compliance.

The need to vet downstream insurance is underscored by the reality that not all parties have the resources to ensure that their insurance programs comply with the insurance requirements in their contracts. Though far from a universal truth, smaller contractors often lack the internal time, dedicated staff, or experience to appreciate fully the complicated nuance of their insurance program or the full scope of their risk exposure. Smaller subcontractors that cannot afford an in-house risk management team or outsourced risk management services typically rely on their brokers to procure the coverage demanded of them in their contracts.

However, smaller unsophisticated brokerage firms or agencies are not always attuned to evolutions in the coverage landscape, which can range from the identification of coverage issues latent in specific endorsements to the creation of new legal precedent impacting policy language construction. Meanwhile, insurers often will introduce a slew of exclusionary endorsements into a subcontractor's program, irrespective of the subcontractor's risk profile or awareness, making it incumbent on the subcontractor to identify problematic endorsements and negotiate their removal.

For example, a contract with a roofing subcontractor on a residential project will typically require the subcontractor to procure commercial general liability (CGL) insurance covering liability arising out of its work and add a host of entities, including the owner and general contractor (GC), as

additional insureds on a primary and noncontributory basis. If the GC were to obtain and review the subcontractor's full CGL policy, it would not be unusual for the GC to find the following troublesome endorsements.

- Additional insured endorsements with privity language limiting coverage to the entity in direct contractual privity with the subcontractor, which is typically the construction manager or GC and not the owner or other upstream parties listed in the contract
- Height exclusions precluding coverage for liability arising out of work above three stories
- Exclusions precluding coverage for liability arising out of residential projects

Ensuring Compliance

An unanticipated work scope can also contribute to the challenge of complying with insurance requirements. Although subcontractors might engage in various scopes of work for a variety of projects, their insurance programs may not be revisited midyear or on a project-to-project basis to ensure compliance with individual contracts. Though not without cost, the most obvious solution is usually the best one: to review the subcontractor's insurance and, when problematic or insufficient endorsements are encountered or the absence of necessary endorsements realized, work with the subcontractor to rectify the coverage deficiencies and obtain proof of same.

While it may seem like the onus to ensure compliance with contractual insurance requirements should fall on the subcontractor, in practical terms, this is a challenge to be borne by all parties because failure to procure the required insurance can create costly problems for upstream parties.

When the intended risk transfer fails (i.e., a GC or owner is unable to obtain additional insured coverage in the face of a third-party liability claim), upstream parties are then saddled with the cost to defend and indemnify the third-party claim, in addition to the cost of bringing a claim against the subcontractor for breach of contract, all of which add delay and cost to the project. This problem is exacerbated further depending on the jurisdiction the GC or owner is in. For example, if operating in New York, the state's labor laws paired with the phenomenon of high jury verdicts make the value of subcontractor insurance paramount.

Having established that a signed contract with broad insurance provisions is not enough to ensure risk transfer, the question arises of how to practically implement a subcontractor insurance vetting process that will not in itself create exorbitant costs and delays for projects. For owners and GCs hiring dozens of subcontractors, it is no doubt a challenge to collect and review subcontractors' insurance policies and effectively monitor the correction of coverage deficiencies.

Nonetheless, as is the case with all costs associated with risk management, the savings realized in transferring risk downstream will outweigh the costs associated with administering a subcontractor insurance vetting program. The focus should be on what program format is most suitable given the size and sophistication of the upstream entity in need of the vetting process.

The ideal, if not always practical, vetting process would entail collecting full copies of all subcontractors' liability policies a couple months before they begin work on the project, reviewing each for compliance with the contractual insurance provisions, and keeping the subcontractors off-site until each respective review is completed and any deficiencies corrected. Depending on the size of the project, this setup may require devoting a full-time employee to administering the insurance vetting project or alternatively contracting this process out to a broker, risk management consultant, or coverage counsel.

Challenges to Comprehensive Vetting

The time and effort that underlie a comprehensive insurance vetting process should not be underestimated. Obtaining full copies of liability policies can prove challenging, as incorrect or incomplete documents are often mistakenly sent—certificates of insurance and/or policy declarations are helpful but not a substitute for a complete policy. While the actual process of reviewing the policies can generally be fixed, the time invested in the next step of addressing detected coverage deficiencies will vary depending on (1) the sophistication and resources of the subcontractor and/or broker representative and (2) the flexibility of the insurer furnishing coverage. Even though the requested insurance coverage is available in the market, the efficacy of procurement can be tied to a subcontractor's bargaining power and the insurer's risk assessment.

Given the practical time and cost constraints inherent in insurance vetting, owners and GCs may consider only administering this process in connection with contracts above a certain dollar value. For example, if a signage subcontractor is only providing \$3,000 of work for the project, it may not be cost-effective to vet its insurance policies or realistic to expect it to dispense additional premium to remedy coverage deficiencies. Additionally, the risk associated with a subcontractor's scope of work may be another factor in considering whether to subject that subcontractor to the insurance vetting process. The risk profile of a subcontractor installing signage less than two stories off the ground is likely less concerning than that of a roofing subcontractor, and the resources associated with vetting the former subcontractor may be better allocated to the latter.

Admittedly, collecting full policies from subcontractors can be document intensive. At a bare minimum, the vetting process should require the submission of (1) policy declarations and schedules of forms for all liability policies, (2) copies of additional insured endorsements and primary and noncontributory endorsements for the primary CGL policy, and (3) full copies of excess policies, which are typically manuscript but significantly shorter than primary policies. Having the declarations provides confirmation of the named insured, policy limits, policy period, and the policy number, while the schedule of forms enables identification of any problematic endorsements (e.g., titles such as "Residential Exclusion" or "Limitation of Coverage for Designated Work"), which can be requested on an as-needed basis for review.

The additional insured and primary and noncontributory endorsements are arguably the most important endorsements to review, as they set the foundation for the owner or GC obtaining coverage under the subcontractor's policy and thereby protecting their own insurance programs. Obtaining full excess policies is typically the only way to confirm the requested coverage is being provided, as they are often manuscript and a schedule of forms will not reveal limitations in the excess coverage form.

Most critical to the success of any insurance vetting program is for the administrator to be proactive and diligent in obtaining policy documents and ensuring coverage deficiencies are being actively remedied. This may require weekly calls with subcontractors or their broker representatives and, potentially, direct calls with underwriters, as well as the implementation of mechanisms for ensuring compliance, such as withholding payment or postponing start dates pending verification of compliance.

For less-sophisticated subcontractors and/or brokers, part of the process will involve educating the parties on the coverage issues. Ultimately, the vetting process should improve the performance of the subcontractor's insurance, who has a vested interest in ensuring its insurance program responds to the insurance requirements it has contracted to procure. Thus, when collaborating with subcontractors to address insurance deficiencies, it is helpful for all parties to appreciate that proposed coverage remedies are not merely a short-term benefit to upstream parties but rather help to guarantee subcontractors get the insurance they purchased and mitigate against the need for breach of contract disputes with upstream parties. Engaging in this type of exhaustive review also helps the downstream entity in the long term, as many common modifications will improve risk transfer for other projects.

Conclusion

A thorough and efficient subcontractor insurance vetting program can help realize intended risk transfer and, with proper planning, be performed with minimal to no impact on project scheduling. Moreover, awareness of the scope of subcontractor coverage before a claim arises makes procurement of insurance more transparent, allowing parties to demand sufficient coverage and to proactively address potential deficiencies. In time, the implementation of vetting programs has the potential to inform the standard quality of subcontractor insurance programs, keeping insurers from attempting to issue illusory or inadequate coverage, and in doing so benefits all contracting parties to major construction projects.

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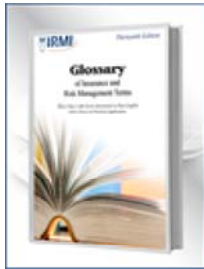
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