BINDING AUTHORITY
Insurance Coverage Decisions: Issued Today - Impact Tomorrow
White and Williams LLP
Randy J. Maniloff
maniloffr@whiteandwilliams.com

August 5, 2009

No Cash For Flunkers: California Appeals Court Penalizes Insureds that Do Not Follow the ABCs of Risk Management

It has always appeared to me that folks from the commercial underwriting and claims departments must not sit together in the company cafeteria. A lack of communication and shared experiences between these two groups is the only explanation for how they could evaluate the risks of insuring contractors so differently.

As claims sees it -- the underwriters' view of insuring contractors is one that only Flora, Fauna and Merryweather could pull off. It goes something like this – If you insure a contractor, they'll farm out some, and perhaps a lot, of their work to sub-contractors. In doing so, the insured-contractor will of course have an agreement with its sub-contractor requiring that the sub-contractor defend and indemnify the insured for certain liability. So the fairy tale continues, that agreement will also require the sub-contractor to maintain its own insurance, and, what's more, that insurance policy will name the insured as an additional insured. And, with a final wave of the underwriting wand, the insured's own policy will provide that it is excess over any insurance that names the insured as an additional insured.

Of course this is an oversimplification, but the fact remains that insurance companies insure contractors with an expectation that the insured-contractor will follow some basic risk management/risk transfer techniques vis-a-vis its use of subcontractors, thereby minimizing the insurer's exposure.

Unfortunately for insurers, unless they are issuing policies to the Felix Unger's of contractors, it is often the case that their insured did not do everything, or sometimes anything, to effect any risk transfer to its sub-contractors. This is the hand that the claims department is often dealt, and it is not the idyllic picture that the underwriter sees when prospectively evaluating a risk.

Most contractors, without the benefit of lawyers, and sometimes relying more on personal, than contractual, relationships when choosing their subcontractors, are simply not in a position to take the various steps (complex and tedious, at that) to achieve all of the risk-transfer benefits that they could. And, besides, as far as the contractor is concerned, it did in fact do everything needed to achieve risk transfer – it bought an insurance policy, didn't it? By doing so, not only has the contractor transferred the risk of its own liability to its insurance company, but it has also shifted to the insurer all of the consequences of its failure to follow basic risk management/risk transfer techniques.

In other words, who pays for the contractor's failure to use a contract that contains a hold harmless cause? Who pays for the contractor's failure to require its sub-contractors to maintain their own insurance? And who pays for the contractor's failure to ensure that the contractor is an additional insured under any policy that the sub-contractor did obtain? In each case the answer is the same – and it is not the contractor.

Some insurers have grown tired of paying the price for their insureds' *laissez faire* approach to risk transfer and risk management. They have begun to include endorsements in their policies that essentially preclude coverage to the insured for a loss arising out of a sub-contractor's operations, if the insured did not obtain a hold harmless agreement from the sub-contractor and proof that the sub-contractor is insured (and sometimes also proof that the insured was named as an additional insured on the sub-contractor's policy). In other words, some insurers are making their insureds real partners in the insurance relationship by requiring them to have some skin in the game when it comes to prudent risk management. You can try to educate the insureds about doing business prudently as a contractor, but that may be slow going. The fastest way to teach them will be if there are financial consequences for the failure do their lessons.

Yesterday the Court of Appeal of California issued a decision (unpublished) that addressed an endorsement of this type. At issue in *North American Capacity Ins. Co. v. Claremont Liability Insurance Co.* was a Contractors Warranty Endorsement that provided as follows:

> In consideration of the premium charged, it is hereby understood and agreed that such coverage as is afforded by this policy shall not apply to operations performed by independent contractors unless: [¶] 1. The insured has received a written agreement from each and every independent contractor holding the insured harmless for all liabilities incurred by the independent contractor. [¶] 2. The insured has obtained certificates of insurance from each and every independent contractor indicating that the independent contractor will maintain similar coverage as provided by this policy and with limits as shown in the above schedule, unless otherwise agreed to in writing by the company. Failure of the independent contractor to maintain similar coverage as provided by this policy and with limits as shown in the above schedule shall not invalidate this policy but in the event of such failure, the company shall only be liable to the same extent as we would have been had the independent contractor maintained such coverage and limits of insurance.

North American Capacity at 6, n.5.

The case has some quirks in that it was "insurer vs. insurer" and involved various cost sharing and collateral issues (for a construction defect claim). But all of that is beside the point. Given that these Contractors Warranty Endorsements are becoming more popular, and as there is not a lot of case law addressing them, the court's discussion of the endorsement is what's important here.

The court examined the Contractors Warranty Endorsement contained in the Claremont policy and enforced it against an insured that failed to comply with its terms for eight of thirteen sub-contractors that it had retained for a project. The court, concluding that the endorsement was a condition of coverage and was conspicuous, plain and clear, held as follows:

> … JDG [general contractor] knew, or is presumed to have known, of this precondition prior to acceptance of the Claremont policies. JDG could have protected itself by obtaining from its independent contractors agreements for indemnity and certificates of insurance before entering into the policy or by seeking modification of this policy term, e.g., by paying a larger premium. Indeed, JDG's president testified, and the trial court found, that it was JDG's normal practice to obtain hold harmless agreements and certificates of insurance for projects on which JDG worked. Merely requiring that JDG continue its normal business practice of obtaining hold harmless agreements and certificates of insurance as a precondition to coverage did not render either the Claremont primary or umbrella insurance contractors warranty endorsements impossible of performance.

> We find the "clear and explicit" meaning of the contractors warranty endorsements, as used in their "ordinary and popular sense" by a layperson establishes a precondition of coverage as to work done by subcontractors for whom JDG failed to secure both a written hold harmless agreement and a certificate of insurance. The trial court therefore did not err in finding the contractors warranty endorsement enforceable under the facts of this case.

North American Capacity at 19.

For insurers that are using these endorsements and perhaps not aggressively enforcing them or for others considering their use for the first time, *North American Capacity* may be a push that they need in that direction.

A copy of the August 4 decision from the California Court of Appeal in *North American Capacity Ins. Co. v. Claremont Liability Insurance Co.* can be accessed here:

http://www.courtinfo.ca.gov/opinions/nonpub/B207878.PDF

Please let me know if you have any questions.

Randy

Randy J. Maniloff
White and Williams LLP
1800 One Liberty Place | Philadelphia, PA 19103-7395
Direct Dial: 215.864.6311 | Direct Fax: 215.789.7608
maniloffr@whiteandwilliams.com