TECHNICAL INFORMATION PAPER SERIES: CONSTRUCTION CONTRACT MANAGEMENT

USE CAREFUL PLANNING TO DRAFT CONTRACTS THAT WORK FOR YOU AND YOUR PARTNERS.

Contracts are an integral element of doing business, particularly in a complex industry such as construction. Their importance cannot be overemphasized, regardless of whether you're a contractor, subcontractor or a wrap-up sponsor. Well-written contracts clarify agreements, improve project outcomes and create good working relationships between the contracting parties.

Generally speaking, organizations are legally responsible for their action or inaction that directly leads to injury, property or economic damage. However, common, state and federal laws usually permit parties to a business agreement to make contractual arrangements that deal with the financial burden of loss.

Transferring risk. Unfortunately, construction contracts are often an under-addressed or even overlooked step in the risk management process. In this Best Practices, developed by The Hartford, we'll focus primarily on how contracts can be used to transfer risk.

This information will help you properly manage contracts from a risk transfer perspective. It reflects our first-hand experience working with construction clients like you, including input from our professionals in:

- Risk Engineering
- Claims
- Legal – reflecting our knowledge obtained from many judicial decisions

WHAT MAKES A CONTRACT LEGALLY BINDING?

A contract is a legally enforceable promise between two or more parties. In construction, these agreements often require one of the parties to pay or indemnify the other party for a loss they suffer in fulfilling the terms and conditions of the contract.

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An effective risk management tool. For a contract to be legal, there must be an offer, an acceptance and consideration. Since a contract is the framework of the agreement between the parties and will establish which party has assumed or negated a particular risk, you shouldn't enter into this agreement without the advice of an attorney familiar with contract law. Contracts have important legal and insurance consequences that'll impact your business. When used properly, contracts are an effective way to manage risk.

Get it in writing. Contracts may be written or oral. Written agreements, when properly drafted, provide a clear understanding to which each of the parties has agreed. Unwritten agreements, while legally enforceable, often create problems. Agreements and understandings negotiated in good faith are sometimes misinterpreted at a later date, particularly after a loss has occurred. That's why oral agreements are generally not recommended.

IDENTIFY YOUR RISK MANAGEMENT GOALS

Before you negotiate an agreement, you need to understand your company's approach to risk management.

Risk management is a systematic and practical process by which your business cost-effectively manages its resources and activities to achieve a business objective. It involves organizing, planning, directing and controlling resources to minimize the financial impact of an event upon your business.

Begin drafting your contract long before you reach the negotiating table. You should have a clear vision of your company's risk management objectives in mind. This allows you to make decisions that:

- Are cost-effective
- Balance expenditures for risk financing with those for risk control
- Support the proper allocation of funds among an organization's risk management activities and its general operations

There's no substitute for proper planning. Deals that are negotiated hastily, or with incomplete information, often work to the detriment of the party least capable of handling them. Sometimes, when you're unable to negotiate a fair and equitable deal for both parties, it makes sense to walk away. Therefore, establishing a walkaway position is critical.

THREE CONTRACT ESSENTIALS

In drafting a contract, you should consider three key points:

1. **The scope of the agreement.** Contracts that don't address all of the terms and conditions of the agreement may cause outcomes neither intended nor desired.
2. **The legal enforceability of the contract.** Contracts that violate public policy or statute are generally unenforceable and worthless.
3. **The ability of the parties to manage risk.** Transferring the responsibility for payment is an effective technique as long as the other party has the capability to honor its financial commitment.

KEY ELEMENTS OF A CONTRACT

If you decide to use a contract to address indemnification, your construction contract should address the following elements before you begin doing any work. Although there may be more, depending upon the scope of the project, the agreement should minimally address:

- Who the parties are, including names and addresses
- The work being done: The description of the job should be specific, particularly if some of the work is to be performed off-site.

You'll also need to address change orders, completed operations and defective work claims.

- **All the terms and conditions of the agreement.** Agreements that are incomplete, or those not executed in a timely manner, often lead to problems. Be sure to include every aspect of the job, even if it seems inconsequential.
- **Choice of law.** Generally, parties should specify which state's law applies to their contract. In the event of a claim, this will help a court interpret the agreement consistent with the intent of the parties. You should also understand that even with this agreement, courts will use their good judgment in attempting to arrive at an equitable resolution.
- **Incorporation by reference problems.** The contract should include all of the agreements as part of the document. Generally, courts look unfavorably upon agreements that attempt to expand a party's liability by reference to another document. By carefully considering and addressing this issue beforehand, you have an opportunity to help a court interpret the agreement consistent with your intent.
- **Workers' compensation.** Indemnification agreements may waive the tort immunity that an employer has for its employees under exclusive remedy.
- **Attorney's fees.** When a party is entitled to indemnification, it's generally entitled to recover attorney's fees incurred in defending a claim. These fees may be significant.
- **The actual indemnification agreement.**
- **Insurance requirements, if appropriate.**

MANAGING RISK THROUGH INDEMNITY AGREEMENTS

With an indemnity agreement, one party to the contract, the indemnitor, agrees to pay another, the indemnitee, if the latter suffers a loss. These clauses are widely used in construction contracts to control distribution of losses and to clearly identify who must pay. The three types of hold-harmless clauses used in construction contracts are broad form, intermediate form and limited form.

- **Broad form.** This form transfers the entire risk of loss from the indemnitee and to the indemnitor, regardless of fault, even if the indemnitee's sole negligence is responsible for the liability.
- **Intermediate form.** With this agreement, the indemnitor assumes all liability, except for the actions where the indemnitee is solely at fault. Intermediate forms impose contractual liability on the indemnitor for indemnitee negligence. Under this form, the indemnitee could be liable for up to 100 percent of the claim, even if he is only 10 percent at fault.
- **Limited form.** With this clause, the indemnitor assumes liability only for its own negligence. The limited form is a restatement of the common-law principle that one is liable for the consequences of his or her actions that lead to injury or damage.

HOW COURTS VIEW INDEMNIFICATION CLAUSES

Typically, courts apply the general principles of contract law in interpreting agreements presented to them. They will try to enforce the contract and indemnification provisions as negotiated by the parties in good faith. Before you draft and negotiate indemnity provisions, you should be aware of the standards that courts generally use to interpret indemnity provisions:

- Courts will analyze the plain language to determine the true intent of the parties.
- Courts will assess the agreement as a whole, considering provisions such as indemnity clauses to assess the meaning of the contract terms.
- Courts will consider relevant prior or contemporaneous evidence as a way to understand the intent of the agreement.

However, they usually won't consider this information to contradict or modify the terms of a written agreement:

- Courts will enforce the indemnity clause against the drafter of the agreement when ambiguity creates two or more interpretations.

Statutes against broad form. A number of states have statutes that prohibit broad form indemnification, and many of these states also limit intermediate language. Because of their exculpatory nature, these agreements are sometimes considered unfair to at least one of the parties or inconsistent with good public policy. However, some states will allow these agreements if they're expressed in clear and unequivocal terms. Consider current state statutes when negotiating your contracts. If you don't, you may have no indemnity protection in the event of a loss.

Exercise caution with multi-state operations. It's also important to be cautious regarding differences in state law. Contractors involved in multi-state operations should be aware that state statute differences might be problematic. For example, states have different statutes of limitations and duty to provide a safe place to work laws. These need to be considered prior to entering any agreement. What's enforceable in one state may be unenforceable in another.

MANAGING RISK THROUGH INSURANCE AGREEMENTS

The ability of the indemnitor to honor its financial commitment is a key consideration. To reduce the possibility that an indemnitor will be unable to honor its contractual obligation, the indemnitee to the agreement often requires the indemnitor to purchase liability insurance to cover the indemnification requirement.

Understand your contractual obligations. To adequately protect your business from loss, you should understand what's covered by your liability insurance policies and those of the other parties. Generally, contractual provisions obligating one party to obtain insurance for the other don't violate anti-indemnity statutes. If the firm you're doing business with is using an insurance company, there are important issues to consider whether you're a general, prime or subcontractor or even a wrap-up sponsor. Your perspective may be different, but the issue isn't.

These considerations include:

- **Insurance requirements.** All contractors should be required to maintain insurance for workers' compensation, general liability and automobile. The contract should also specifically state the required limits. There's no hard and fast rule as to the right limit amount. Some suggestions:
  - For general liability, request a minimum of $1 million per occurrence and $2 million aggregate.
  - For automobile, request $1 million.
  - For workers' compensation, request statutory coverage with $1 million for coverage B.

For all coverage, higher limits may be warranted, depending upon the particulars of the job. Also consider if the coverage is offered on an occurrence or claims-made basis or as part of a self-insured-retention (SIR) program. It could make a difference.

- **Named insured.** Regardless of your status, you should resist all requests to add named insured coverage onto your policy. Named insured coverage could trigger coverage for events neither intended nor contemplated. There are more effective ways to handle these requests.
- **Additional named insured.** When state statutes invalidate indemnity provisions, the agreement to name the indemnitee as an additional insured on the indemnitor's insurance policy can effectively

reallocate the cost of risk. This coverage grant can address the indemnitee's coverage needs for a specific job. However, the language needs to be precise.

- **Primary insurance.** A primary insurance clause can ensure that one policy will be primary to any other insurance. Typically, the party providing the primary insurance should have its insurer endorse its policy accordingly.
- **Severability of interest/cross liability clause.** The severability of interest endorsement ensures that claims by one insured against another are treated as if separate policies had been issued to each insured. This could be an issue when more than one additional insured is being defended under a single policy of insurance.
- **Indemnification and hold harmless.** These agreements generally reflect a conscious risk assumption by one party, and a risk transfer by the other.
- **Waiver of subrogation.** In all cases, the right of subrogation may be waived prior to the occurrence or accident. This could be a significant form of protection.
- **Cancellation provisions.** All insurance contracts contain cancellation provisions. While it's often difficult to keep track of other policies, you need to be certain that the information provided to you is accurate and current.
- **Certificates of Insurance (COI).** COI are intended to be evidence of insurance, not an insurance contract. The document should include relevant information, such as the named insured, policy number, policy terms, limit and coverage by line of business. Watch for nonstandard forms and wording. Additionally, depending on circumstances, it may be desirable to consider a separate policy to provide Owner's and Contractor's Protective (OCP), Railroad Protective or Joint Venture coverage. Your underwriter from The Hartford can provide additional information to you.

Plan for success. With careful planning, you can create a contract that effectively manages risk while improving project performance, reducing costs and establishing a strong working relationship among all the parties involved. Your attorney, independent agent and The Hartford can help you develop a program that responds to your specific insurance and risk management needs.

LEARN MORE.

For more information, contact your Risk Engineering consultant from The Hartford today or visit us online at **THEHARTFORD.COM/RISKENGINEERING**.

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