Insurances and Bonds in the Construction Industry

Risk Response Planning through Transference of Risk:
The Basics

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Presentation Summary

- In this presentation we will discuss the transference of risk through:
  - Common insurance agreements in the construction industry
  - Common types of surety bonds

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Insurance

- A two-party agreement where, for a consideration, one party indemnifies the other in the event of a prescribed peril (fire, accident, vehicle crash).
- For a consideration (money) paid to the insurer, the insured receives payment in the event of a bona fide claim
- Based on the probability that many are insured but few will claim

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Surety Bonds

- A three-party agreement
- A third party, the Surety, agrees to take responsibility for the work of a Contractor who cannot finish the work under contact to an Owner.
- Not indemnification
  - The Surety will recover costs from the Contractor.
  - A bond is more a line of credit, not an insurance

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Concepts

- Indemnification
  - One party holds the other party harmless
  - In other words, "you give me a considerations (pay me some money) and I will see to it that if an accident happens, such as a fire, I will give you the amount of money you need to repair the damages."

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Concepts

- Privity of Contract
  - Only the parties of a contract may enforce the contract
  - Third parties who are not a party to a contract cannot enforce the contract
    - Beswick v. Beswick
  - Importance: Subcontractor's claim against contractor' insurance policy
    - All parties named in an insurance agreement

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Concepts

- Right of Subrogation
  - Right of a party to seek damages against a party who is not the insured who caused the damages
  - Addressed in insurance agreement by naming "all Subcontractors" under Builder's All Risk Policy

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Concepts

- Principal
  - Party undertaking the obligation (Contractor)
- Obligee
  - Party providing the consideration (Owner)
- Surety
  - Third party providing an assurance that the Principal will finish the work

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Concepts

- Lien
  - An interest in a property
  - A painter does painting work on a project. The painter does not get paid by the Contractor for that work. The painter can file a "lien" against the property.
  - In other words, the painter has now established a financial interest in the property.
  - All liens must be satisfied before any financial transactions dealing with a property can be executed

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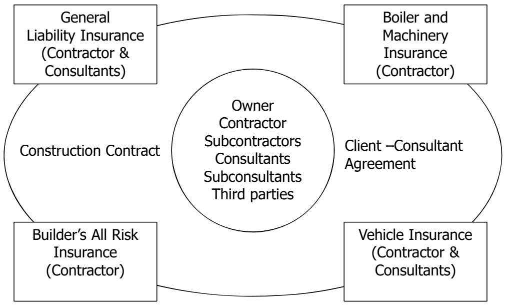
Risk Response Planning – Transfer Risk



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Insurances

- General Liability Insurance
- All Risk Property Insurance
  - Builder's Risk Insurance
- Comprehensive Boiler and Machinery Insurance
- Automobile Insurance
- Contractor's Equipment Insurance
- Professional Liability Insurance

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General Liability Insurance

- What is covered:
  - Insures Contractor against Bodily injury
  - Property damage caused by accident
  - Non-bodily personal injury
- Arises from real or alleged defects in the Work
- An annual insurance maintained for 6 years following completion of the work

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General Liability Insurance

- What is excluded:
  - Injuries and damage caused by automobiles and other craft (separate insurance)
  - Claims under Worker's Compensation (separate insurance)
  - *Damage to property on which the Contractor is working (separate insurance)*
  - Must be repaired due to faulty work
  - Pollution liability (separate insurance)
  - Profession Liability – errors and omissions insurance (separate insurance)

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General Liability Insurance

- Wrap-up Liability Insurance
  - Covers all parties in a project including Contractor, Subcontractors, Owner and Consultants

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Builder's All Risk Property Insurance

- What is covered:
  - Insures Contractor and assigned other parties (Owner) against damage to the work in progress.
- Claim may arise from perils such as fire collapse, windstorm, vehicle impact, theft, vandalism, water damage, or flooding (interior)
- Project specific insurance

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Builder's All Risk Property Insurance

- What is excluded:
  - Contractor's equipment (cover's only the property on which the work is being done, both permanent and temporary construction)
  - Vehicles that may also have been damaged by the peril (separate insurance)
  - Property off-site such as supplies and materials that have not yet been delivered to the site

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Builder's All Risk Property Insurance

- Excluded Perils:
  - Pollution
  - Wear and tear
  - Delays, interruptions, loss of use and penalties
  - Floods and earthquakes
  - Mechanical and electrical breakdown (Separate insurance)
  - Freezing

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Builder's All Risk Coverage Extensions

(Additional Coverage at a Cost)

- Soft (Indirect) Costs
  - Fees and interest on builder's loan due to lengthening of project financing
  - Business interruption
  - Increased costs due to remediating damage (overtime, etc.)
  - Off premises services

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Comprehensive Boiler and Machinery Insurance

- What is covered:
  - Pressure vessels and mechanical and electrical equipment once it has been tested and is operational
  - Accidental damage to equipment
- Claims may arise from cracking, arcing, nature, or mechanical breakdown
- Coverage does not start until equipment is connected and operational

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Comprehensive Boiler and Machinery Insurance

- What is excluded:
  - Accidents caused by those causes listed in Builder's All Risk insurance such as fire

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Vehicle Insurance

- What is covered:
  - Liabilities associated with driving an owned vehicle:
    - Personal injury
    - Damage to property
    - Third party liability and Accident Benefits
  - Liabilities associated non-owned vehicles:
    - Employee using own car for work purposes

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Professional Liability Insurance

- Protects Parties against errors and omission performed in delivering profession services
- Always carried by Architects
- Usually carried by Engineers
- Carried by Design Builders who are delivering profession services as a part of the overall contract even though those services may be provided by a contracted professional

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Surety Bonds

- A three-party agreement
- A third party, the Surety, agrees to take responsibility for the work of a Contractor who cannot finish the work under contact to an Owner.
- The Contractor (the Principal) and the Surety share the responsibility to finish the project.

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Types of Surety Bonds

- Bid Bond
  - Financial protection to the Owner should the Contractor fails to or refuses to enter into a formal contract after its bid has been accepted by the Owner
- Performance Bond
  - Provides the Owner or Contractor with protection should the Contractor be unable to finish the work, typically through a default of the Contractor

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Types of Surety Bonds

- Labour and Material Payment Bond
  - Reduces the risk of liens through ensuring that outstanding payables for labour and materials will be made

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Performance Bond: Example A

- The contractor is not able to finish a project
- Assume that the surety opts to complete the project themselves. The surety becomes the contractor
- The surety is responsible for the total cost, less the balance of the contract price, even if this amount exceeds the face amount of the bond

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Performance Bond: Example A

- The decision as to how to proceed is at the surety's discretion and will depend on their experience and resources, as well as the reason for the contractor's default
- Most frequently, the surety will advance money or bonds to assist the defaulting contractor through a period of financial or legal difficulty

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Performance Bond: Example A

- Assume that the surety opts to allow the Owner to complete the project and that the additional costs are $190,000
- The penal sum under the performance bond is equal to the cost to the owner to complete the work minus the balance of the contract price:

  Penal Sum = 190,000 – 60,000 = $130,000

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Performance Bond: Example A

- The surety pays the lesser of the penalty sum or the performance bond, in this case the performance bond of $100,000 is paid by the surety to the owner
- The surety will seek to recover this amount from the principal under the indemnity agreement
- The difference between the performance bond and the penalty sum is a monetary damage to the owner.

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Performance Bond: Example B

- Assume that the surety opts to allow the owner to complete the project and that the additional costs are $90,000
- The penal sum under the performance bond is equal to the cost to the owner to complete the work minus the balance of the contract price:

  PS = 90,000 – 60,000 = $30,000

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Performance Bond: Example B

- The surety pays the lesser of the penalty sum or the performance bond ($100,000) in this case the penalty sum of $30,000 is paid by the surety to the owner
- The surety will seek to recover this amount from the principal under the indemnity agreement

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Performance Bond

- When the contractor becomes unable to complete the work, the surety has three options regarding how to proceed:

1. Assist the principal to remedy the default by advancing funds to the principal but not taking control of the project.
2. Take control of contract performance and complete the work by engaging another contractor or by retaining the principal and subsidizing project operations and actively directing the work
3. Allow the obligee to complete the project by engaging another contractor and, when the work has been completed, pay money to the obligee for any excess costs incurred in completing the work

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Irrevocable Letters of Credit

- Alternative to a Surety Bond
- Contractor provides the Owner with an irrevocable line of credit backed by the Contractor's bank
- Contractor must provide collateral for the line of credit which the bank can seize in the event of default.
- Promise of "cash on demand"
- Liquid security

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Summary

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