Transferring and Financing Risk in Public Contracts

A Presentation By:

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• Evaluating / Transferring / Financing Risk
  • Insurance
    • Additional Insured
    • Cross-Liability Coverage
    • Claims-Made vs. Occurrence Coverage
    • Contractor’s Insurance Will Respond First
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  • Navigating Anti-Indemnity Laws
  • Force Majeure
• Safety Program Requirement
• Bid / Payment / Performance / Maintenance Bonds
• Insurance Archeology
Overview of Presentation

• This presentation will focus on different types of contracts and how to evaluate, transfer and finance risk
Every time your city enters into a contract, it should:

- Evaluate the risk the contract presents for the city, today and in the future;
- Determine whether to accept that risk or transfer it to another party;
- Determine how that risk will be financed, either by your city or by others; and
- Confirm appropriate insurance or self-insurance of the party to bear the risk.
Five Categories of Municipal Contracts

Most municipal contracts fall into five categories:

1. Goods and non-professional services
2. Professional services;
3. Leases;
4. Inter-agency agreements;
5. Public works contracts
Different Contracts Have Different Risks

- **Goods and Services:**
  - When does ownership transfer to your city?
  - Who corrects defective products?

- **Public Works**
  - Who pays for bodily injury or property damage for accident on construction site?

- **Professional Services:**
  - Who pays for design or construction management errors or omissions and resultant damages?
Evaluating Contracts for Risk

- Who are the parties involved?
- What kind of work is being performed?
- What type of accidents or losses could occur?
- What is the worst-case scenario in terms of financial loss and/or injury to persons or property?
- Are the responsibilities for the risks appropriately allocated to those in the best position to control them?
- What is each party’s ability to manage the risks and absorb the losses?
- Is the contract legal and enforceable?
- Ensures contractors take on their fair share of liability
- Ensures cities aren't culpable for losses that are out of their control
- Critical to reducing a city’s exposure, regardless of the size or scope of a project
Three Components of Risk Transfer

- Insurance procurement, including obtaining Certificate of Insurance and, where possible, key endorsements and/or a copy of the insurance policy itself;
- Hold harmless / indemnification / defense agreement;
- Waiver of subrogation
California cities can transfer losses that are partly their fault, but cannot transfer losses that are solely their fault.

Important to avoid overly broad risk transfer agreements that may be unenforceable.

Contracts should be as specific as possible regarding scope of work and what each party’s financial responsibilities are.
Financing Risk

- Risk financing activities include:
  - Arranging for sources of funds to pay for losses that may occur; and
  - Using those fund sources when needed.
- When transferring risk, important to confirm contractor can pay for any losses that arise out of their operations
- While not perfect, insurance is often most reliable risk financing method available
Insurance: contractual arrangement to transfer and distribute risk in exchange for fixed charge (insurance premium)

Requiring contractors providers to buy insurance is a means to finance loss payments

Cities should request to be named as additional insureds on policies carried by contractors

Combining hold harmless and indemnity agreements with insurance provides more financial security
Insurance: Additional Insured

- When a city is named an additional insured, the insurer:
  - Must provide a defense if your city is named in suit;
  - Must pay city’s defense costs along with providing liability insurance;
  - Cannot dismiss its obligations to your agency or a third party claimant due to bankruptcy of the named insured (contractor);
  - Cannot subrogate against your agency, even if it is legally liable for the loss;
  - Will most likely include coverage for personal injury losses under general liability
Insurance: Additional Insured

Additional insured status is not a substitute for a hold harmless and indemnity agreement, for several reasons:

- Insurance will only pay for claims that are covered by the terms of the policy
- Insurance policies have a limit of liability defining the most an insurance policy will pay for a loss
- If claim is not covered or contractor does not have enough insurance, the hold harmless and indemnity agreement gives your city the right to be reimbursed directly by the contractor
Cross-Liability Coverage

- Ensure liability insurance provides coverage for cross liability
- Cross liability coverage has two basic benefits:
  - Insurance applies separately to each insured against whom claim is made and each insured is entitled to a separate defense. Thus, city is entitled to coverage even if another insured has done something to cause the insurer to deny their coverage.
  - Allows one insured to make a claim against another insured. Without cross liability coverage, city would not be indemnified by contractor’s insurance for city’s claim against contractor.
Claims-Made / Occurrence Coverage

- **Occurrence coverage – best option:**
  - Claim can be made today for an injury or damage that occurred 20 years ago
  - Insurer will investigate and settle the claim as long as the injury or damage occurred during the policy period and is covered by policy

- **Claims-made coverage:**
  - Claim must be first made during policy period (or extended reporting period)
  - Injury or damage must occur before end of policy period
Insurance: Contractor’s Insurance is Primary and Noncontributory

- Contracts should require contractor’s insurance – whether general liability, automobile, or umbrella coverage – pay for claims first on primary and noncontributory basis:
  - Contractor’s insurance must pay first and its limits be exhausted before city’s insurance is accessed
  - Contractor’s insurer may not seek contribution from city’s insurer
Insurance: Flow Down

- Because no privity between city and subcontractors, important to require that contractor impose city’s contractual requirements on its subcontractors

- A flow down to subcontractor binds subcontractor to terms and conditions of flow down provisions, which are typically the same as the prime contract
Endorsement that prohibits insurer (that steps into shoes of insured after it pays a loss) from recovering the money it paid on a claim from your city even if it caused the loss

Avoids city being held liable for jobsite claims

Essential in workers’ compensation coverage when contractor’s employees will interact with city employees and property

- Contractor will be required to pay additional premium and provide additional data
Difference Between Certificate Holder and Additional Insured

- **Certificate Holder:**
  - Contractor has coverage
  - Insurer indemnifies contractor
  - Contractor reimburses city

- **Additional Insured:**
  - City entitled to all insurance policy benefits including
  - Right to defense
  - Right to enforce implied covenant of good faith and fair dealing
Indemnification

- Practice of guaranteeing a third party claim against your counterparty

- Three categories of indemnity:
  - Type I: All claims including those caused by negligence of either indemnitee or indemnitor
  - Type II: General indemnity in which indemnitor protects only against its own negligence
  - Type III: Indemnity extends only to negligence of indemnitor; can be voided by even passive negligence on part of indemnitee
Hold Harmless

- Hold harmless (waiver and release) agreements address claims between parties to a contract, whereby one party agrees not to seek damages from the other for their own losses.
- Types of claims normally waived in hold harmless agreements are:
  - Damage to property owned by one party;
  - Consequential losses, such as lost income as a result of property damage; and
  - Subrogation between parties associated with third party claims.
Duty to Defend

- Obligated party assumes costs and burden of defending the other
- Does not entitle counterparty to seek contribution of defense costs after court decision on third party claim
- Negotiate who controls defense
- Negotiate whether settlement or strategy requires consent of other party
- Second-most hotly contested contract term; more common in professional services agreements
- Capping liability at the value of the contract provides the guarantor with an assurance that it will not lose more than it could have gained
- Important any limitation of liability be exclusive of applicable insurance
- Consider imposing mutuality of obligation
Navigating Anti-Indemnity Laws

- Prohibit a public agency from forcing a contractor to indemnify the agency for its “active negligence”

- Subcontractors cannot be forced to indemnify or insure another party for that other party’s “active negligence or willful misconduct,” for defects in the project’s design provided to the subcontractor, or for claims arising outside the scope of the subcontractor’s work.
Force Majeure

- A force majeure (“Act of God”) clause allocates risk of loss if performance is hindered, delayed, or prevented because of an event the parties could not have anticipated or controlled such as floods, fires, strikes, acts of war, etc.

- With advent of COVID-19 pandemic, crucial to ensure COVID-19 cannot be used to excuse performance in new contracts since all parties were already aware of the pandemic and therefore should account for it in pricing and predicting contractual performance.
Safety Program Requirement

- Safety programs foster a proactive approach to “finding and fixing” workplace hazards before they can cause injury or illness.
- Safety requirements should be a vital part of bid specifications.
- Cities should first screen their contractors carefully before entering into a contract and then require their contractors to establish and maintain a safety program.
Bid / Payment / Performance / Maintenance Bonds

- **Bid Bond**: Ensures contractor proceeds
  - If contractor awarded bid fails/refuses to sign contract or provide bonds and insurance, tender to Bid Bond
  - Bid Bond Surety obligated to pay difference between apparent low bidder and next lowest bidder up to 10% of bid price

- **Payment Bonds**:
  - If over $25K [PCC Section 7103; Civil Code 9550]
  - 100% of Project [Civil Code Section 3248]
Bid / Payment / Performance / Maintenance Bonds

- **Performance Bond:**
  - Ensures contractor completes project
  - Obtaining a bid bond pre-qualifies the bidder for a performance bond surety has already determined that principal has resources to bid on contract

- **Maintenance Bond:**
  - Protects city once construction is completed
  - In place for specified time period against defects and faults in materials, workmanship, and design that could arise during a “warranty” period.
  - Many performance bonds automatically include a 1-year maintenance bond without additional charge
Insurance Archeology

- Identify untapped funding for investigation and cleanup / repair of contaminated / damaged sites
- Historical, occurrence-based policies even over 100 years old can still be viable for providing coverage for present day liabilities
- Even if historical policies have been lost/destroyed, insurance archeologists can find actual policies or evidence of them
Benefits Municipalities / Landowners facing:

- **LITIGATION**
  - CERCLA, Superfund, Polanco/Gatto Act, Nuisance and Trespass claims

- **REGULATORY ORDERS**
  - Investigative Orders
  - Cleanup and Abatement Orders
  - TMDLs; SQOs
Insurance Archeology

Benefits of Historical Insurance:

- Duty to defend
  - Defense includes site investigations
  - No policy limits
- Duty to indemnify
  - Pay for damages
  - Policy limits
Insurance Archeology

- Historical Insurance Coverage for:
  - Environmental Claims
  - Landslides
  - Subsidence
  - Flood
  - Landfills
  - Contaminated Soils
Examples of other long-tail exposures include:

- Asbestos
- Toxic exposures
- Construction defect
- Product recall
- Sexual misconduct
- Medical device failure
- Pharmaceutical side effects
Insurance Archeology

- When your city requires insurance of tenants or operators:
  - Require actual insurance policies where possible
  - Don’t rely on “Certificate of Insurance”
QUESTIONS?

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