

Chapter XIV

BONDING AND INSURANCE

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Introduction

Surety bonds and insurance policies are often deemed to be similar contracts, often because it is insurance companies that write the bonds. However, there are several differences between suretyship and insurance. The surety relationship is a tripartite relationship involving the surety (bonding company), principal (general contractor or subcontractor) and obligee (owner (or general contractor if it is a subcontractor bond)). In an insurance policy there are only two parties, the insurer and the insured. The insurer agrees to indemnify the insured against a loss resulting from an unknown or contingent event. In suretyship, the bonding company agrees to answer for the default or debt of the contractor or subcontractor. The purpose of this chapter is to highlight some of the major issues that seem to reoccur with regard to both suretyship and insurance.

I. MICHIGAN PUBLIC WORKS BOND STATUTES

Under Michigan law, it is not possible to file a lien against a public project. To provide a remedy for unpaid subcontractors and suppliers, the statute, MCLA 129.201 et seq, requires a labor and material payment bond on projects where the value of the contract is above \$50,000.00 and where the owner is a “governmental unit.” Governmental units include a county, city, village, township, school district, public education institution, other political subdivision, public authority, or public agency.

The contractor is required to provide the payment bond and generally the amount is the same as the contract amount. The contractor rarely has a choice in deciding on the form of the bond. The American Institute of Architects have prepared AIA Document A312 and this payment bond has seen widespread use. From the viewpoint of the contractor, a payment bond claim is generally combined with a breach of contract claim by the subcontractor, alleging an extra or disputing a backcharge. The contractor’s surety or bonding company will look to the contractor to resolve the matter and generally will only get directly involved if the contractor is incapable of dealing with the claim for financial reasons or if the owner has defaulted the contractor. If the claimant has contacted the surety and if the contractor resolves the claim, it is good practice for the contractor to promptly notify the surety that the matter has been resolved.

A “claimant” is defined as a “person having furnished labor, material, or both, used or reasonably required for use in the performance of the contract.” “Labor and materials” includes that part of water, gas, power, light, heat, oil, gasoline, telephone service or rental of equipment directly applicable to the contract.”

A claimant who does not have a direct contractual relationship with the general contractor is required to give two separate notices in order to proceed with a payment bond claim against the surety:

- (a) 30 days after furnishing the first of material or labor, the claimant has to give the general contractor a written notice describing the work that is being provided, the location, and identifying the party who requested the labor or materials; and
- (b) 90 days from the date of the last labor or materials, there has to be a written notice to the general contractor and the governmental unit stating the amount claimed and the name of the party to whom the material or labor was furnished. For each notice, certified mail is required.

For a claimant with a direct contractual relationship with the general contractor, there are no notice requirements; however, a suit against the bond must be started within one year from the date of final payment to the general contractor.

The statute also requires a performance bond by which the bonding company undertakes certain obligations if the general contractor is unable to complete performance of the work. For a subcontractor performance bond, the surety is obligated to the general contractor. Under certain conditions, the performance bond surety agrees to complete performance of the work. The surety generally has two or three options and often a replacement contractor completes the work. Performance bond claims are not as common as payment bond claims and for a surety to get directly involved in a project based on a performance bond, there generally has to be a serious problem between the owner and contractor, such as a threat or declaration of default.

There is a separate bond statute for state highway projects, MCLA 570.101, et seq. The notice provisions are different than the non-highway statute and subcontractors and materialmen have to provide notice to MDOT within 60 days after furnishing the last labor or materials. A suit against the payment bond must be filed within one year from completion and acceptance of the project.

For federal projects, the Miller Act, 40 USC 270A, et seq, requires payment and performance bonds. Under the Miller Act, claimants can include subcontractors and suppliers to general contractors and first tier subcontractors but do not include suppliers to materialmen or suppliers to second tier subcontractors. For claimants who do not deal directly with the general contractor, notice is required by certified mail to the general contractor within 90 days from the last of the labor and material including an identification of to whom the labor or material was furnished. Lawsuits against the payment bond must be filed within one year from the date of the last labor or material provided.

BONDS ON PRIVATE PROJECTS

Contracts on large private projects generally require performance and payment bonds and if so, the notice requirements and the time limits for filing suits are controlled by language contained in the bond. On a successful project, the general contractor has little reason to be concerned with the requirements of the bonds. However, on any occasion where the contractor is performing as a subcontractor, it is critical for the contractor to examine the requirements of the bonds just in case it is necessary to make a claim against the surety. The same rationale applies to public projects. If the contractor is wearing a different hat, as a subcontractor, then it is important to be aware of the notice requirements contained in the statutes if a claim has to be made. For example, on a private project, it is generally no excuse for a subcontractor to claim that it did not have a copy of the bond and did not get a copy until it was impossible to comply with the notice requirements.

Whether it is a public job or a private job, if the general contractor receives notices from sub-subcontractors or suppliers stated that they are performing work on the project or even that they have not been paid, the general contractor should be glad to receive the notices. The notices provide the general contractor with the opportunity to check with its subcontractor to make sure that there are not going to be any payment problems. However, actual claims by sub-subcontractors and suppliers to subcontractors can be distracting to the general contractor. Ever worse, if the subcontractor has used payments to pay debts unrelated to the project, the general contractor could end up paying twice. For example, if the sub-subcontractor has a valid claim against the general contractor's bond, then the surety will have to pay the sub-subcontractor. The surety will then ask the general contractor to reimburse the surety based on the indemnity agreement the contractor had to sign to get the bond. The general contractor certainly would have the right to pursue the subcontractor for this loss but by then, the subcontractor could be out of business. Payment bond claims can even include unpaid fringe benefits by a defunct subcontractor. Therefore, it is important for the general contractor to assist its surety in determining whether the sub-subcontractor has provided timely notice pursuant to the statute or pursuant to the bond itself it is a private project. It is also important for the general contractor to have a system in place to determine whether its subcontractors are paying their own subcontractors. For example, the subcontractors could be

required to list all of their own suppliers and sub-subcontractors on a sworn statement and then to provide waivers the following month showing that all suppliers and sub-subcontractors have been paid.

In addition, the general contractor should actually read the payment bond furnished by its surety. On a public project, the bond should not contain notice provisions that are more generous than the statutory notice provisions. If the provisions are more generous, then a supplier or sub-subcontractor might be able to maintain a valid claim against the bond even if it has failed to comply with the statutory notice requirements.

For some private work, it may be possible to avoid bonded projects but certainly for the larger projects, bonds will be required and the contractor will have to establish, through its insurance agent, a relationship with a surety company. A surety company's underwriting requirements usually include:

- Accurate and complete financial information;
- Reviewed or audited year-end statements for a three to five year period;
- Organization charts and resumes of key personnel;
- Lists of completed projects, job references and work on hand;
- Supplier reference letters;
- An indemnity agreement signed by the contractor, and perhaps requiring signatures of the owners and spouses (depending on the size and strength of the company).

II INSURANCE COVERAGE IN CONSTRUCTION **COMMERCIAL GENERAL LIABILITY POLICY**

A thorough discussion of insurance coverage for construction losses and defective work claims would require two or three volumes. The purpose of this article is to discuss certain major issues. Owners generally bring claims against the contractor. Claims are sometimes brought by insurance companies of other entities based on subrogation, which means that the insurance company has already paid a claim to its insured and is now seeking a recovery from the contractor. Most of the litigation and controversy pertains to the interpretation of the commercial general liability (CGL) policy, including the meaning of "occurrence," and the meaning of certain exclusions including "business risk" and "work product."

In general terms, the commentary and court cases have stated that the CGL policy is meant to cover contractors for tort liability and not for damages due to defective workmanship. A claim filed by the contractor with its insurance carrier requires an "occurrence" which causes "bodily injury" or "property damage." The standard CGL policy contains several exclusions that limit the scope of coverage. In turn, these exclusions have their own exceptions.

The majority of courts have held that defective workmanship is not an "occurrence." One rationale used by the Courts is that liability policies are not supposed to provide coverage for "business risk." A minority of courts have held that defective workmanship can qualify as an "occurrence" by using a more subjective standard, which states that unexpected consequences of an intentional act (the work) can result in an "occurrence" covered by the policy. If defective work can qualify as an "occurrence," the insurance company could still rely on the "work product" exclusion as a reason for denying coverage. The intent of the standard exclusions is to exclude from coverage the risk that a product will fail and will require repair or replacement. The exclusions were intended "to make the insured responsible for predictable and limited business risks, while protecting the insured against catastrophe." Honeycomb System, Inc. vs. Admiral Insurance Co., 567 F.Supp 1400, 1408 (D.Me 1983).

INSURER'S DUTY TO DEFEND

Michigan courts have provided some guidance on some of the major issues involving the CGL. In the case of Radenbaugh vs. Farm Bureau, 240 Mich App 134 (2000) the Michigan Court of Appeals dealt with the common question of whether the insurance company has to defend a suit even if most of the claims against the insured would not be covered by the policy. The Court stated the general rule that "if

the allegations of the underlying suit arguably fall within the coverage of the policy, the insurer has a duty to defend its insured.” The result is that in Michigan an insurance company’s duty to defend is broader than its duty to indemnify. From the contractor’s point of view, the duty to defend is important because the cost of defending a large lawsuit is substantial. Even if there is a coverage dispute with the insurance company at the end of the suit, the contractor is better off having the insurance company defend the suit by the third party. Therefore, the contractor should never automatically assume that there is no insurance coverage for a particular claim or no duty to defend.

The Radenbaugh case also dealt with the definition of “occurrence” under the CGL that stated:

“Occurrence” means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”

The case dealt with erroneous schematics and instructions to contractors hired for the construction of a basement foundation and the erection of a home. The insurance company refused to defend and asserted that the policy did not insure the policy holder for breach of contract, breach of warranty, and shoddy workmanship claims. The Court then discussed the assertion by insurance companies that the defective workmanship of a contractor, “standing alone,” was not the result of an occurrence within the insurance policy. The Court agreed but went on to ask the question of whether the insured’s defective workmanship caused damage to the work or property of others. If so, then the damage was considered to be “unforeseen, unexpected, and unintended and therefore was “an occurrence” and covered by the policy.” The Court gave an example of a case where there was a defect in radiant heat tubing that caused a leak that in turn caused damage to furnishings and required the floors to be removed and re-poured to replace the tubing. The Court held that there was insurance coverage for the furnishings and floor replacement but not for the cost of the new tubing itself. A contractor, therefore, when faced with a claim for defective workmanship or a defective product, should determine if the claim includes damage to other areas of the site, other than the product itself.

NOTICE TO INSURANCE COMPANY

On occasion, a contractor may face a dilemma based on the following language of the standard policy:

We will pay those sums that the insured becomes **legally obligated to pay** as damages because of “bodily injury” or “property damage” to which this insurance applies.

Based on the above language, some insurance companies state that in order to be “legally obligated” under the CGL policy, there has to be a judgment from a court entered against the insured. Therefore, a lawsuit would have to be filed in order to result in a judgment. This scenario creates a problem for the contractor who has received a claim from an owner concerning property damage at the site that the contractor is obligated to repair under its contract with the owner. A responsible contractor may decide to proceed with repairs in order to minimize delay to the project and to avoid a breach of contract claim by the owner. However, by doing so the contractor then has the risk that the insurance company, in the absence of a lawsuit, will deny coverage under the CGL policy. One could presumably make the argument that the contractor is better off waiting for a lawsuit from the owner rather than facing up to its contractual responsibility to repair the damage.

The best way for the contractor to avoid such a dilemma is to contact the insurance company immediately whenever any facts arise that might result in a claim. The contractor should then take steps to convince the insurance company that there is coverage under the policy and that it would be unwise and inefficient for all concerned to wait for a lawsuit from the owner. If the contractor delays in providing notice to the insurance company, the company may later assert that the contractor has waived its right to claim coverage under the policy.

COVERAGE FOR DEFECTIVE WORK OF SUBCONTRACTORS

As already discussed, the general rule is that there is no coverage for defective workmanship of the contractor unless perhaps there is damage to work or property owned by others. However, work performed by subcontractors may not be a business risk that the general contractor cannot control. Thus, an argument can be made that defective subcontractor work is a fortuitous occurrence that would be covered by the policy. The result would be an exception to the general exclusion for defective work contained in the CGL policy. Pursuant to this exception, the contractor is provided coverage for property damage arising out of the defective work of its subcontractors.

Recently, however, the Insurance Services Office, Inc. ("ISO") has begun offering two new endorsements that can be made a part of the contractor's CGL policy. The endorsements, which are identified as CG22 94 and CG22 95, eliminate the subcontractor exception to the exclusion. By doing so, the result could be a reduction in coverage for many contractors. It is wise for a contractor to discuss the issue with its insurance agent and determine whether the contractor's CGL policy includes the new endorsements. To obtain coverage for subcontractor's defective work, it may be necessary to pay an increased premium and that cost issue is one that the contractor can discuss with the agent.

DESIGN/BUILD ERRORS AND OMISSIONS COVERAGE

The wider use of design build projects has created some insurance coverage issues. The traditional delivery system for a project divides the design and construction services between two separate entities whereas design build places design and construction responsibility in a single entity. One goal of design build is to complete the project quicker and cheaper than the traditional project delivery. However, the CGL policy typically excludes design errors and omissions. In addition, the design professional E&O policy typically excludes construction errors and risks associated with construction management. The result is that on a design build contract, the contractor needs to confer with its insurance agent and determine that E&O coverage is purchased for the design aspect of the project. If the contractor uses an outside company to perform the design services, then the contractor should require the outside company to furnish evidence that it has its own E&O coverage.

BUILDERS RISK INSURANCE

Builders risk insurance provides insurance for damages occurring during construction of the project and terminates once the project is completed or occupied. Usually the construction contract identifies the type of insurance required for the project along with the parties that are to be named as insurers. The general contractor may be required to obtain the policy even though the owner or developer may pay for it. In the absence of a contract provision requiring builders risk insurance, the contractor could be responsible for repairing and replacing work that is damaged or destroyed during construction. Therefore, it is important for the contractor to check the construction contract before commencement and determine if there is a builders risk provision.

The American Institute of Architects A-201 General Conditions require the owner to purchase the builders risk policy. If the owner does not intend to purchase the insurance, the owner has to inform the contractor in writing prior to commencement of the work. The contractor is to then obtain the builders risk insurance and the cost, through a change order, is to be charged to the owner. If the contractor does not receive the written notice, the owner is responsible for uninsured damage to the contractor's work during construction.

INSURANCE COVERAGE FOR MOLD CLAIMS

Mold and sick building claims have increased dramatically. Much of the attention pertains to residential construction. However, there is a growing concern that the commercial construction industry will be substantially affected also. For example, if mold is discovered in a workplace, there is a risk that a group of employees will sue the landlord or owner who will then drag the architect and contractor into the suit, perhaps even years after the construction was completed. When faced with such a claim or potential claim, as always it is important for the contractor to promptly notify the insurance company. Due to the complexity of mold insurance issues, it may also be necessary to confer with the insurance agent and legal counsel.

The law pertaining to mold and insurance claims is evolving but disputes will pertain to exclusions in the insurance policy, both standard exclusions and new exclusions created by the insurance industry to deal with the increased number of large damage claims. Most CGL policies have an extensive pollution exclusion. An argument can be made that mold is not the kind of "pollutant" meant to be included in the exclusion. However, at least one court has held that the exclusion applies because mold damage resulted from "discharge, escape or dispersal" of "fungi" and was, therefore, a pollutant. Lexington Ins. Co. vs. Unity/Waterford-Fair Oaks, Ltd, 2002 W.L. 356756 *3 (N.D. Tex).

Other standard business risk exclusions such as faulty workmanship and the "your product" exclusion will no doubt be the subject of litigation between insureds and insurers. There is also a completed operations exclusion that excludes claims for damages that arise out of the insured's completed work. Such an exclusion could be asserted by the insurance company with regard to a mold claim. On the other hand, there is also insurance coverage called "completed operations hazard coverage" which is meant to provide coverage for injuries or damages sustained after the insured's work has been completed. The contractor can confer with the insurance agent with regard to whether to purchase completed operations coverage.

As already noted, the insurance industry has been adding endorsements to liability policies in order to either exclude or reduce coverage for mold claims. The exclusions include the "fungi or bacteria exclusion" which excludes cleanup and remediation costs along with personal injuries. An additional endorsement is called the "limited fungi or bacterial coverage endorsement" and provides a limitation on the damages for property damage or bodily injury arising out of a "fungi or bacteria" incident. The contractor should ask the insurance agent whether the current policy and any renewals include the new endorsements and should at least inquire as to the cost of not having the endorsements on the policy.